COMMITTEE ON WAYS AND MEANS

HEARINGS BEFORE THE

SUBCOMMITTEE ON OVERSIGHT
(Volume 1 of 2)

104th Congress
1995-1996

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(Volume 2 of 2)

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CHILD WELFARE PROGRAMS

HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

OF THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDRED FOURTH CONGRESS

FIRST SESSION

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CHILD WELFARE PROGRAMS

MONDAY, JANUARY 23, 1995

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT,
Washington, D.C.

The subcommittee met, pursuant to call, at 10:04 a.m., in room B–318, Rayburn House Office Building, Hon. Nancy L. Johnson (chairman of the subcommittee) presiding.

[The press release announcing the hearing follows:]

ADVISORY
FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON OVERSIGHT

FOR IMMEDIATE RELEASE
January 13, 1995
No. OV-1

CONTACT: (202) 225-7601

JOHNSON ANNOUNCES HEARING ON CHILD WELFARE PROGRAMS

Congresswoman Nancy L. Johnson (R-CT), Chairman of the Subcommittee on Oversight of the Committee on Ways and Means, today announced that the subcommittee will hold a hearing to examine whether federal child welfare programs could be streamlined to better help children. This hearing will supplement the Subcommittee on Human Resources' welfare reform responsibilities under the *Contract with America.* **The hearing will be held on Monday, January 23, 1995, in room B-318 of the Rayburn House Office Building, beginning at 10:00 a.m.**

In view of the limited time available to hear witnesses, the subcommittee will receive testimony from invited witnesses only.

BACKGROUND:

Child welfare services are intended to help improve the conditions of children and their families or to provide substitutes for functions parents have difficulty performing. The primary responsibility for child welfare services rests with the states. Each state has its own legal and administrative structures and programs that address the needs of children, and there are many differences among the states.

The Federal Government also provides funding to the states for a broad range of child welfare services. For example, the Federal Government provides funds to states for, among other things, family preservation and family support services, foster care, independent living, and adoption assistance programs. Federal child welfare and foster care programs are intended to operate in concert to help prevent the need for out-of-home placement of children and, in cases where such placement is necessary, to provide protection and permanent placement of the children involved.

Congress enacted legislation in 1980 (Public Law 96-272) designed to encourage states to use child welfare funds to help keep families together and prevent the placement of children in substitute care. The 1980 legislation required that if the federal appropriation for the child welfare program exceeds a set amount in any year, states would lose funds above this amount if they failed to put into place a number of child protections. Over time, these "incentive funds" have grown in importance.

In response to Public Law 96-272, the Department of Health and Human Services (HHS) identified a total of 18 child protections required by section 427 of the act. Under what came to be known as "427 reviews," the caseload of each state receiving incentive funds is examined to determine compliance with these child protections. Among the reviews HHS requires states to perform for each child are:

(1) a description of the type of home or institution in which the child is to be placed;

(2) a discussion of the appropriateness of the placement;

(3) a plan to achieve placement in the least restrictive (most family-like) setting;

(4) a plan for placement in close proximity to the parents' home, consistent with the best interest and special needs of the child;

(5) a statement of how the responsible agency plans to carry out the voluntary placement agreement or judicial determination;

(6) a plan for ensuring that the child will receive proper care; and

(7) a plan for providing services to the parents, child, and foster parents to improve conditions in the parents' home and facilitate the return of the child to the home, or into a permanent placement.

FOCUS OF THE HEARING:

The hearing will focus on our nation's 14 years of experience with "427 reviews" to determine whether they have served to improve the lives of children. Over the past several years, a consensus has been developing that the 427 reviews impose a costly and burdensome workload on the states without providing any discernible benefit to the children in need of child welfare and foster care services. The subcommittee will hear testimony from state child welfare administrators and other interested parties to examine whether elimination of 427 reviews and block granting federal child welfare services and foster care programs back to the states will strengthen the states' abilities to deliver these important services to children.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS

Any person or organization wishing to submit a written statement for the printed record of the hearing should submit at least six (6) copies of their statement by the close of business on Tuesday, February 7, 1995, to Phillip D. Moseley, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements wish to have their statements distributed to the press and interested public at the hearing, they may deliver 200 additional copies for this purpose to the Subcommittee on Oversight office, room 1136 Longworth House Office Building, at least one hour before the hearing begins.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. Statements must contain the name and capacity in which the witness will appear or, for written comments, the name and capacity of the person submitting the statement, as well as any clients or persons, or any organization for whom the witness appears or for whom the statement is submitted.

4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and the public during the course of a public hearing may be submitted in other forms.

*****

Chairman JOHNSON. Good morning. It is a pleasure to have you all here today for the initial hearing of the Oversight Subcommittee. The Oversight Subcommittee operates as a watchdog to ensure that the laws and programs which Congress has enacted are being carried out properly. While Congress passes laws, it is the executive branch that carries them out. Thus, one goal of congressional oversight is to ensure that the executive branch is administering the laws in a way that Congress intended.

Another goal is to review whether or not the original law is still relevant to today's problems. I can think of no other area where this oversight role is more critically important than in reviewing the effectiveness of Federal child welfare and foster care programs. The children served by Federal and State welfare programs are the most vulnerable members of our society. All too often they are the victims of neglect, abandonment, and physical and sexual abuse. No other segment of our society needs the protection of vigilant oversight more than these children.

Under our system of government, the primary responsibility for providing child welfare services rests with the States. Each State has its own legal and administrative structures and programs to address the needs of abused and neglected children and there are significant differences among the States. However, the Federal Government also has provided funds to the States for a broad range of child welfare services, including family preservation and family support services, foster care, independent living, and adoption assistance services, and this subcommittee has a long and honorable history in helping to develop those Federal programs that are then implemented through a partnership of enormous importance to the well-being of the children of America.

In 1980, Congress enacted the Adoption Assistance and Child Welfare Act, which was designed to encourage States to use child welfare funds to help keep families together and prevent the placement of children in substitute care. After the legislation's passage, the Department of Health and Human Services identified a total of 18 separate child protections required by section 427 of the act. Under what became known as the 427 reviews, the foster care caseload of each State is examined to determine whether the State has complied with these child protections.

Our hearing today will focus on our Nation's 14 years of experience with section 427 reviews. Clearly, there was some improvement in State child welfare and foster care programs in the years immediately following passage of the 1980 act. By 1983, foster care caseloads had dropped to 262,000 children from an estimated high in 1977 of almost 500,000 children. However, that progress has reversed and in recent years the number has been on the rise again. Many child welfare experts attribute this increase to the crack cocaine epidemic which began in the mideighties and the rapid growth of out-of-wedlock births over the past decade.

One of the fundamental underpinnings of the 1980 act was family preservation. In other words, the act was premised on the belief that it is generally in the best interest of children to live with their own families. To ensure that the States were using Federal funds as Congress intended, tight strings were attached to their receipt, including the possible loss of so-called "incentive funds" if the

States failed to put into place the child protections created under section 427 of the act.

While family preservation is certainly a worthwhile goal, we must also recognize that in too many cases today there is no family left to be preserved. A large percentage of the children now in substitute care in the United States have been neglected, physically or sexually abused, or abandoned by drug addicted parents. We need only recall the horrible pictures we saw on our television sets last year of the 18 children found abandoned in a roach-infested Chicago apartment—crawling in dog feces, many were in diapers that hadn't been changed for days—to understand that family preservation isn't always in the child's best interest.

The question we must ask today is whether the structure of current Federal child welfare programs and regulations continues to best serve the interests of abused and neglected children or, as some believe, has it evolved into a system which merely protects growth in the welfare bureaucracy?

Over the past several years, a consensus has begun emerging that while section 427 reviews impose a costly and burdensome workload on the States, they do not provide any discernible benefit to the children in need of child welfare and foster care services. The irony is that a State may pass its section 427 reviews with HHS but a court still may rule that its child welfare programs are so mismanaged that it will place the programs under court receivership and that is exactly what is happening around the country in many States today. Sadly, this is happening even in my own State of Connecticut, which has been a leader in children's services.

This naturally leads to the question if a State's child welfare programs are to be found in compliance with Federal child protections yet the programs are mismanaged and aren't protecting the children, what steps should be taken to improve the situation?

For years, the States have been telling Congress they need more flexibility to decide how to target Federal child welfare funds to where their particular needs are greatest. The time has come to listen to what the States have been telling us. Child welfare resources must be refocused to serve the fundamental purposes of protecting children.

Today, the subcommittee will consider whether elimination of the 427 reviews and block granting Federal child welfare services in foster care programs back to the States will strengthen the States' abilities to serve children in crisis.

We also want to hear the witnesses' reviews about whether certain Federal standards and data gathering and reporting requirements will be necessary to ensure that the States use Federal block grant funds to serve the best interests of America's children.

We will receive testimony from the administration, from State and child welfare administrators, and from advocacy groups and individuals on the frontline helping to serve abused and neglected children.

I want to welcome all the members to our first Oversight Subcommittee hearing, all the members of the committee, as well as the witnesses and others who have joined us today. Our first witness is Mary Jo Bane, Assistant Secretary for Children for the Department of Health and Human Services.

Before I welcome Ms. Bane, let me yield to my ranking member, the gentleman from California, Mr. Matsui.

Mr. MATSUI. Thank you very much, Madam Chairwoman. I appreciate very much the fact that you are yielding to me for an opening statement.

I would like to commend you on the chairmanship on this very important Oversight Subcommittee. Many of you may not know this, but Chairwoman Johnson chaired the oversight subcommittee in the Connecticut Legislature and did a great job, from what I understand, in talking to other people in terms of the oversight of many of the programs. We look forward to working with you and obviously the other members of the subcommittee, as well.

If I may just be very brief in my remarks, some are talking at this time about block granting many of the child welfare and AFDC and other social programs of the Federal Government. There is just no question that the child welfare programs themselves, IV–E, IV–B and others, are probably the ultimate safety net for our young children in America. If we block grant, for example, AFDC benefits and we have very strict time limits in those benefits and if, in fact, they are discretionary programs rather than entitlement programs, this will undoubtedly put many young women and children at-risk in America. We will then need a safety net. And of course that safety net will become and always has been the child welfare system. To block grant those programs and put those under a discretionary program would even create more danger to our children. So we, obviously, must look at these programs very carefully. And we appreciate the fact that Mrs. Johnson is calling these hearings today for that purpose.

I would like, if I may, just to make a couple more observations. We must make sure that these hearings, and this hearing today in particular, are not the basis legislating a block granting of these programs. It is my hope that the Human Resources Subcommittee will also conduct hearings on these issues since it is primarily in their jurisdiction. And I would not want any of the members on our side of the aisle to lead anyone to believe that we will be satisfied with marking up legislation in this area just on the basis of the hearings we are holding today and perhaps subsequent hearings as well.

This is an oversight subcommittee. It is not one with substantive legislative jurisdiction. So it is my hope and understanding that we will have further hearings in the appropriate legislative subcommittee.

Second, I think what we need to do is not only discuss block granting and possible savings to the State and Federal Government, but also we need to talk about minimum national standards that will be conveyed along with whatever moneys the Federal Government sends to the States under any kind of program, whether it is block granting or whether it is an entitlement program.

We also need to continue to talk about State maintenance of effort. As you know, in times of recession, it is the States that have been the ones to cut back, and obviously their programs are countercyclical. In times of recession, they need more of an effort for their social programs.

States being so close to their constituents, there is no question that the legislature and the Governors have a tendency to go with public opinion rather than go with what is right. Public opinion affects the local government most greatly and State government second and the Federal Government usually can sit back and make informed judgments. It is very, very dangerous to put these programs in the hands of States in times of recessions because normally they will make decisions based upon what is popular, what gets votes, rather than what is in the right interest of the American public, particularly the children of America who don't vote.

And I might just point out, this has been demonstrated recently in the discussions about entitlement programs. We talk about eliminating the entitlement status of AFDC, of social welfare programs, but no one talks about eliminating the entitlement status of Social Security. Well, it is obvious, senior citizens vote and children and poor people don't vote.

I might also mention, too, we need to talk about quality assurance. When money goes to the States, the Federal Government, those of us who are legislators, have an absolute responsibility that the money of the taxpayers is used efficiently. And we have to make sure we maintain quality assurance. We have to make sure we maintain standards. We have to make sure that there are reviews to make sure the States are not misusing our money.

Let me just conclude by making an observation about the state of children in America. There is no question, the Chairwoman mentioned the Chicago situation where 18 children were left abandoned and discussed the problems with the family preservation programs in America. I wouldn't call that family preservation.

When we passed the family preservation legislation in 1993, there were a number of components. One was early intervention, early intervention into that family to make sure that the child and the mother, particularly the mother, understood how to care for that child, how to nurture that child. In fact, we tried to pattern it after a program in Hawaii where the intervention occurs upon the birth of that child.

We also had in that legislation originally programs for the courts so that the judges would learn what is necessary in making sure that the juvenile justice system worked. We went to Chicago, Ill., and we found that the judge, the juvenile court judge was listening to cases every 5 minutes. It is pretty obvious in that kind of a situation the judge was not able to decide what was in the best interest of that child with the 5-minute review. But unfortunately, that program was cut back.

We only have under $1 billion over the next 5 years, $200 million a year for all 50 States. We can't do it with those kinds of resources. So we are not really talking about family preservation. We are basically talking about giving some limited assistance to States. But if you really want to do family preservation, you are going to have to be willing to put the resources in to do early intervention, making sure the justice system works and making sure that ultimately, and I conclude with this, the best interest, the best interest of that child is in the minds of the legislatures when we take action.

Thank you, Madam Chairwoman, for this opportunity.

Chairman JOHNSON. Thank you, Mr. Matsui.

Mr. Ramstad, a new member of the Ways and Means Committee, and a valued member of this subcommittee, isn't able to join us at the very beginning of our hearing but would like his opening statement submitted for the record, and it will so be done.

[The prepared statement of Mr. Ramstad follows:]

STATEMENT OF REPRESENTATIVE JIM RAMSTAD
WAYS AND MEANS OVERSIGHT SUBCOMMITTEE
HEARING ON CHILD WELFARE PROGRAMS
January 23, 1994

Madame Chairwoman, I appreciate you holding this oversight hearing on federal child welfare programs, their effectiveness and how they might be reformed.

Recently, some rather outlandish and inaccurate charges have been made about the Contract with America's welfare reform legislation.

But it should be made clear that it is the states -- not the federal government -- that have primary responsibility for child welfare services. In fact, state and local authorities make the decision thousands of times each year to remove children from their families and place them in foster care or group homes because of abuse and neglect.

The federal government has steadily increased its financial support for a broad range of child welfare services, particularly through the use of "incentive funds." But with this rise in funding has also come more and more federal regulations.

These regulations, known as "427 reviews," require states to report on 18 child protections. While they may be well-intentioned, it is not clear they have improved the quality of child welfare services. What is clear is that compliance with the "427 reviews" has become a real burden on state and local administrators of child welfare programs, diverting needed resources.

By one count, there are currently 38 federal child welfare and child abuse programs for low-income people, with a total of more than $4.3 billion in funding this year. As we explore ways to reform the complex web of federal welfare programs, one of our top priorities must be to give states the flexibility to more efficiently and effectively meet the needs of their residents.

I hope the witnesses before us today -- Administration officials, state child welfare providers and administrators and child welfare advocates -- will offer some valuable suggestions and proposals that will help us meet this goal and better serve the children in these programs.

I thank all of the witnesses for being here today and look forward to their testimony.

Chairman JOHNSON. Are there other members of the committee who would like to make a comment before we proceed with the Assistant Secretary's testimony?

If not, Secretary Bane. Welcome. It is a pleasure to have you.

STATEMENT OF HON. MARY JO BANE, ASSISTANT SECRETARY FOR CHILDREN AND FAMILIES, U.S. DEPARTMENT OF HEALTH AND HUMAN SERVICES

Ms. BANE. Good morning, Madam Chairman and members of the committee. I have submitted a longer statement for the record and I would like to summarize my testimony at this point.

I am the Assistant Secretary for Children and Families in the Department of Health and Human Services. My agency has responsibility for the range of child welfare programs that serve the most vulnerable children and families in this Nation, often at times of terrible crisis.

It is a real pleasure to be testifying before you this morning at this very important hearing—I am so pleased you are having it—because of your long history of working for the betterment of child welfare programs. I would like to take advantage of this opportunity to share our vision for strengthening and reforming child welfare services by establishing a strong national leadership role, combined with increased State flexibility. As part of this discussion, I will address the protections under section 427.

A very large and growing number of children have some contact with the child welfare system. In 1992, almost 3 million children were involved in reports of child abuse or neglect. Of these reports, about 40 percent, involving almost 1 million children, were substantiated, that is, found to have some basis. About 17 percent of the children found to be abused and neglected required placement outside their homes in order to assure their protection.

How well we respond to the unique needs and circumstances of these children and their families has enormous consequences for children's safety and for their future development. We believe that there is an emerging consensus in States and communities across the country that child welfare services need dramatic improvement. Ours is a vision where the first priority of child welfare services is to ensure the safety of children and of all family members, where all services build on the resources and strengths of families to help support children's healthy development, where the community is the first line of support for families, and where all communities offer a continuum of services, from informal support services to early prevention, to foster care, reunification, and adoption. To achieve this vision will require both strong national leadership and increased State flexibility.

As a former State child welfare commissioner and now as a Federal official in regular contact with the States, I am personally committed to ensuring that we at the Federal level concentrate our energies where we can have the most effect on high-quality services and outcomes for children and families, rather than on the more narrowly focused enforcement actions of past years.

As you noted, Madam Chairman, I believe that we have in fact made progress since the passage of the landmark Adoption Assistance and Child Welfare Act of 1980, but we still have a long way

to go. One major problem is that the past Federal approach to enforcing the protections under section 427 of the Social Security Act has not been fully effective or fully desirable. Although States made significant progress in the early years after the protections were required, the approach to monitoring has focused both the States and the Department on the literal compliance with procedural requirements, with the content of the paper found in case folders, rather than on the intent of the provisions and the attainment of quality outcomes for children.

Provisions that Congress enacted last year give us new and more flexible tools for working with the States to improve the child welfare system by realizing the vision behind the protections embodied in section 427. We are currently reengineering our approach to monitoring and reviewing State programs, as well as to determining eligibility and assessing the quality of outcomes and practice in State programs.

We will be focusing in new ways on partnerships with the States in development of review plans and protocols; on support for change through technical assistance and corrective action plans; on self-assessment by the States; on the use of automated data and information systems; and on outcomes. We plan to conduct the first pilot tests of these new approaches in the spring and will issue regulations for public comment as required by the legislation in the summer of 1995. We will also be also working in the spring with the States as they develop innovative projects under the new demonstration authority.

We are very eager to work with you as you move forward to consider a variety of approaches to improve program consistency and coherence. As you review approaches involving spending caps, block grants or consolidations, we would like to raise some difficult issues about the potential effects of these proposals that we think we all need to consider. They deal with ensuring basic care and protection for vulnerable children; cushioning the States against unpredictable increases in demand; and achieving national goals for the child welfare system.

Between 1988 and 1993, the rate of reported child abuse and neglect rose 25 percent, partly because of deterioration of the communities where many vulnerable children and families live. The foster care caseload during that period rose by almost 50 percent, reflecting an increased need to ensure the safety of children from the most troubled families, and the numbers of families receiving adoption subsidies nearly tripled.

Chairman JOHNSON. Excuse me, Madam Secretary. I didn't mean for the bell to govern your testimony.

Ms. BANE. I will talk faster.

Chairman JOHNSON. Go ahead.

Ms. BANE. These increases that I have just noted are illustrations of some of the trends that contributed to a tripling of spending on foster care, adoption assistance, and child welfare services over the 1988–93 period. These funds provided basic protections and services to the most vulnerable children in this country. Had a cap on spending been imposed in 1988, these children are likely to have been left at considerable risk, especially since the needs of

these families and children for services are unpredictable and may not diminish.

Federal spending plays an important role in helping States cope with increased demands on their child welfare systems, which vary dramatically across the States. Any block grant that you consider would require the construction of a formula to allocate funds across States.

We did an illustration of the effect that a block grant might have on States by looking at what would have happened if a block grant had been put in place in 1988 using a base of 1987 spending and an allocation formula based on spending in that year. If this type of block grant had been in place, in the aggregate States would have lost two-thirds of what they actually claimed in 1993. Connecticut would have lost 67 percent; California would have lost 66 percent. Only one State would have received more than it actually claimed. The results for all the States are shown in the table attached to my full testimony.

There are, of course, many ways of establishing a level of aggregate spending and many possible ways of distributing it. This illustration is not meant to suggest that that is what this committee or any committee would recommend. But it does illustrate two things. First, it illustrates that demand is unpredictable and States could be seriously disadvantaged by a block grant or spending cap approach. Second, it shows that there are enormous variations among the States which no allocation formula is likely to be able to cope with fully.

Finally, as we consider how best to achieve our national goals for the child welfare system, it is essential to consider the consequences of any proposal in terms of the safety of children and the stability of families, as well as the ability of foster and adoptive families to nurture and raise the children who need them. Given the critical nature of these child welfare services, we must be very careful to construct an approach to change that balances flexibility for the States and communities with the need for a national framework, for accountability for outcomes, and for effective protections for the children and families. We must also assess carefully the likely impact of each approach on States, communities, and families.

We look forward to working with the committee, the Congress, and the States to revitalize these essential services to support the safety and healthy development of children.

Thank you. I am happy to answer any questions at this time.

[The prepared statement and attachments follow:]

TESTIMONY OF MARY JO BANE
ASSISTANT SECRETARY FOR CHILDREN AND FAMILIES
U.S. DEPARTMENT OF HEALTH AND HUMAN SERVICES

Good morning, Madame Chair and members of the Committee. I am the Assistant Secretary for Children and Families in the Department of Health and Human Services, with responsibility for the range of child welfare programs. These programs are extremely important because they serve the most vulnerable children and families in our nation, often at times of terrible crisis.

It is a pleasure to be testifying before you, Madame Chair, because of your long history of working for the betterment of child welfare programs. I would like to take advantage of this opportunity to share our vision for strengthening and reforming child welfare services by establishing a strong national leadership role combined with increased state flexibility to meet their particular needs. As part of this discussion, I will also address the protections under section 427 of the Social Security Act, which I understand is of particular interest to this Committee today.

Background

A very large and growing number of children have some contact with the child welfare system. In 1992, almost 3 million children were involved in reports of child abuse or neglect. Of these reports, about 40%, involving almost 1 million children, were substantiated. About 17% of the children found to be abused or neglected required placement outside their homes to assure their protection.

How well we respond to the unique needs and circumstances of these children and their families has enormous consequences for children's safety and for their future development. Let me illustrate with the story of three young siblings, James, Sara, and Mary. They were removed from their birth family due to severe physical abuse and neglect at ages 3 years, 2 years, and 2 months respectively and placed with two separate foster families. Four years later, after placements with three or more families each, the siblings were finally reunited and placed with an adoptive family in another state, identified through an extensive recruitment campaign. The placement is going well, but the children and their new family are coping with the effects of years of disruption on these young lives. By the time of the adoption, James was described as defiant, acting out, and having delayed speech; at least one of the children had been sexually abused; and a psychiatrist had indicated his grave concerns about Mary's future abilities.

James, Sara, and Mary are lucky in the permanent family they found, but they are far from unusual in their unnecessarily long and difficult path getting there. What are the flaws in the current child welfare system?

- Public child welfare systems have been overwhelmed by recent increases in the number of abuse and neglect reports as well as the increasing complexity and severity of family and community problems such as violence, homelessness, and drug abuse. Too often, despite the best efforts of states and communities, child welfare workers are undertrained and stretched far too thin, particularly given the life and death decisions we ask them to make.

- In part as a consequence of this overburdened system, many children - like James, Sara, and Mary - spend too many years in limbo between permanent homes. Two-thirds of the children in foster care in FY 1990 had been away from their home for one year or more, and 10 percent for five years or more. Almost 60 percent had

been placed in more than one setting during their stay in foster care and almost one-quarter in three or more.

- Often, the child welfare system is isolated from the communities and neighborhoods families live in and from the services that are critically needed by families - such as mental health and substance abuse services, health care, and housing.

- And far too few resources are devoted to prevention, meaning that families often don't get help until after children have been abused or neglected.

We believe that there is an emerging consensus in states and communities across the country that child welfare services should work very differently. In many communities and many states, this new vision is emerging bit by bit. It is a vision where:

- The first priority of child welfare services is to ensure the safety of children and all family members.

- All services build on the resources and strengths of families to support children's healthy development.

- The community is the first line of support for families. While a strong public child welfare system exists, families have access to all kinds of informal family support services in neighborhoods and settings that feel comfortable and are easily accessible.

- All communities offer a continuum of child welfare services, from early prevention to foster care, reunification, and adoption. Because children's healthy development is at the center of all decisions, children spend as little time as possible between permanent settings, returning home or to a loving adoptive family as quickly as possible.

To achieve this vision will require both strong national leadership and increased state flexibility. As a former state child welfare Commissioner and now a Federal official in contact with the states, I am personally committed to ensuring that we, at the federal level, concentrate our energy where we can have the most effect on high quality services and outcomes for children and families, rather than on the more narrowly focused enforcement actions of past years.

The Federal Role

As we move ahead together to reform child welfare services, I would like to reflect briefly on the history of the federal role in protecting vulnerable children and families. Until the mid-1970's, states provided the largest share of resources in the child welfare system, and the federal government largely funded foster care for the poorest children in the system. In 1980, through the Adoption Assistance and Child Welfare Act (AACWA), Congress significantly reoriented federal involvement to direct resources and decisionmaking toward preventing inappropriate removal of children from their homes and providing services that promote reunification of children with their families or identification of other permanent homes as quickly as possible. In addition, Congress recently provided new tools and resources for states to use toward preserving families and preventing children from unnecessarily entering the child welfare system. We share the view held broadly by child welfare professionals in the field that implementation of this vision, and the protections for all children which are at its core, fell far short of its promise.

As we focus anew on how to enable the child welfare system to meet the needs of society's most troubled families, we must balance the need for state flexibility with the Federal role of ensuring accountability for high quality outcomes for children and families. On the one hand, I saw during my years in New York how state and local leaders have often brought an extraordinary commitment of resources, creativity, and innovation to child welfare services. Yet at the same time, there is a widespread consensus that performance in today's child welfare systems isn't good enough, that the consequences for children are untenable, and that performance by individual states varies widely.

The failures of some state systems have been so marked that courts in more than 20 percent of the states have found that the state systems violate the constitutional or statutory rights of the children the systems are supposed to protect. In places like Connecticut, Utah, and the District of Columbia monitors have been appointed for the systems.

I believe that the federal government has a very important role in bringing about changes in these systems. In fact, it is widely accepted that the passage by Congress of the AACWA of 1980 served as a major impetus for many of the efforts at state reform that have occurred in the past 12 years. The law required that children receive basic federally mandated child protections (known as "Section 427 requirements") such as: regular case reviews to determine the appropriateness of service and the progress of families and children; a tracking system to identify the number of children in care and their progress toward permanency; and an up-to-date case plan, which is goal oriented, for each child in foster care. There have been strong, positive results. More children are being adopted more quickly, more efforts are being made to prevent unnecessary removals, and states have implemented procedures to improve case planning and to monitor the status of children in foster care.

Yet, as I have indicated, we still have a long way to go. One major problem is, I believe, that the past Federal approach to enforcing these protections has not been fully effective or desirable. Although states made significant progress in the early years after the protections under section 427 of the Social Security Act were required, the approach to monitoring has focused both the states and the Department on literal compliance with procedural requirements - with the content of the paper found in case folders - rather than on the intent of the provisions and the attainment of quality outcomes for children.

The provisions Congress enacted last year separated implementation of the section 427 provisions from the states' receipt of title IV-B funds under the Social Security Act. We are currently reengineering our approach to monitoring and reviewing state programs, as well as determining eligibility and assessing the quality of outcomes and practice in state programs. Regular review of children's cases is vital to the effort to ensure the safety and health of children in the system. We will be focusing in new ways on partnership with states in the development of review plans and protocols; on support for change through technical assistance and the development of corrective action plans; on self-assessment by states; on the use of automated data and information systems; and on outcomes. We plan to conduct the first pilot tests of these new approaches in the spring, and issue regulations for public comment, as required by the Congress, in the summer of 1995.

In addition to this reengineered role in support of quality outcomes for children, three other important Federal roles have emerged from our consultations over the past two years with states, county and local officials, and community leaders:

- Helping state and local programs succeed through training, technical assistance, and dissemination of ideas and models. State and local leaders do not want to have to reinvent the wheel each time they come upon a problem that someone else has encountered and solved, and they want access to the best national expertise. To meet that need, we have revamped and expanded our system of National Resource Centers, sharply increasing funding and reshaping their mandate in response to concerns and suggestions from child welfare practitioners, including state officials. The five Centers, all operated by nationally recognized experts, are required to provide up-to-date on-site consultation, develop resource and training materials, and conduct research and evaluation in response to the particular needs of states.

- Supporting the development and implementation of automated information systems. State officials have repeatedly told us that both funding and technical assistance from the Federal government are critical to the automation of state child welfare service systems. Effective automation in turn reduces paperwork, frees up workers, and allows states to keep track of child and family needs, services, and flow through the system. We have been active in providing technical assistance, including an innovative partnership with five states, a non-profit organization and two foundations to produce a prototype caseworker-driven automated system. Through this activity we are working with the states to design and develop a system which gives states flexibility and reflects their need and priorities, while ensuring performance and accountability.

- Promoting knowledge and improved results through research, demonstration, and evaluation. The Federal government has a unique role to play in supporting and disseminating research and evaluation, so that states can benefit from the best available knowledge in making their individual policy choices. One recent example of the effective use of research is the Multistate Foster Care Data Archive, a federally funded collaboration with federal, state and university partners located at the University of Chicago, which has compiled and analyzed administrative data from seven large states regarding children's entries, exits and stays in foster care as well as the characteristics of children in the system. The information has been useful to the seven states and has provided key national data on nearly fifty percent of the children in foster care in the nation.

Challenges Posed by Consolidation and Block Grants in Child Welfare

We in the Administration share your belief that child welfare programs must be consistent and coherent rather than fragmented. States and communities must be free to respond flexibly to children's and families' needs rather than being hamstrung by narrow categorical programs and rigid funding streams.

We are eager to work with you as you move forward to consider a variety of approaches to improve program consistency and coherence. We understand that among the approaches under discussion are spending caps, block grants and consolidations of various sorts. As you review these approaches, we would like to raise a number of difficult issues about the potential effects of these proposals that should be considered. They deal with

ensuring basic care and protection for vulnerable children; cushioning states against unpredictable increases in demand; and achieving national goals for the child welfare system.

Between 1988 and 1993, the rate of reported child abuse and neglect rose almost 25 percent, partly because of deterioration of the communities where many vulnerable children and families live. The foster care caseload during that period rose by almost 50 percent, reflecting an increased need to ensure the safety of children from the most troubled families, and the number of families receiving adoption subsidies nearly tripled.

These increases are an illustration of what contributed to a tripling of federal spending on foster care, adoption assistance and child welfare services over the 1988-93 period. These funds provided basic protections and services to the most vulnerable children in our country. Had a cap on spending been imposed in 1988, these children are likely to have been left at considerable risk. We all hope that the family and community circumstances that result in increased numbers of children in the child welfare system will be alleviated. And we hope that increased use by states and communities of preventive services, family reunification services, and adoption will allow a slowing of the growth in foster care spending. But the needs of families and children for these services are unpredictable, and may not diminish. Spending caps have the potential for imposing considerable harm.

Federal spending plays an important role in helping states cope with increased demands on their child welfare system, which vary dramatically across the states. Any block grant requires the construction of a formula to allocate funds across states. As an illustration of the effect a block grant might have on states, we looked at what would have happened if a block grant had been put in place in 1988, using a base of 1987 spending and the block grant parameters described for AFDC and other welfare programs in H.R. 4. If this type of block grant had been in place, in the aggregate, states would have lost about two-thirds of what they actually claimed in 1993. Connecticut would have lost 67 percent of what it actually claimed; California would have lost 66 percent; New Jersey would have lost 34 percent. Only West Virginia would have received more than it actually claimed. Results for all the states are shown in the attached table.

There are of course many other ways of establishing a level of aggregate spending and many possible ways of distributing it. This example is not meant to suggest that this particular proposal or any other is on the table. But it illustrates two things. First, it illustrates that demand is unpredictable and that states could be seriously disadvantaged by a block grant approach. Second, it shows that there is enormous variation among the states, which no allocation formula is likely to be able to cope with fully. It is important to think very carefully about the potential implications of any spending cap or block grant formula that might be devised.

It is also important to think very carefully about which programs are combined into any block grant, to ensure that our national goals for the child welfare system are promoted. Our vision for child welfare includes a continuum of high quality services, from services that help families deal with their problems before they become abusive or neglectful, to residential care for the most seriously troubled children.

A rational funding mechanism should encourage states to continue making improvements in their child welfare services, without penalizing states that are slower than others to begin these efforts. A rational funding mechanism should also neither skew the financial incentives toward out of home care, nor deny

states the funds they need to ensure safe placements for children who need them. The Congress last summer authorized a limited number of state demonstrations to use child welfare and foster care funds more flexibly. These demonstrations, with careful evaluations, should provide a good deal of information and experience useful in designing a funding mechanism best suited to the vision.

Finally, as we consider how to best achieve our national goals for the child welfare system, it is essential to consider the consequences of any proposal in terms of the safety of children and the stability of families, as well as the ability of foster and adoptive families to nurture and raise the children who need them. For example, under the Adoption Assistance program, states currently provide support to families who adopt children meeting the criteria developed by that state for special needs, until the child is 18; the Federal government is obligated to provide reimbursement for those expenditures. If adoption assistance were to be blended into a block grant, states could be forced to choose whether to continue payments to current adoptive families or to enroll new ones, and families who had chosen to give their love and support to a child on the expectation that they could receive some modest help in paying for services required to meet the child's need would face a painful dilemma.

Conclusion

Given the critical nature of these child welfare services, we must be careful to construct an approach to change that balances flexibility for states and communities with the need for a national framework, accountability for outcomes, and effective protections for children and families. We must also assess carefully the likely impact of each approach on states, communities, and families. We look forward to working with this Committee, the Congress, and the states to revitalize these essential services to support the safety and healthy development of children.

I'd be happy to answer any questions at this time.

Hypothetical Impact in FY 1993 if a Child Welfare Block Grant Similar to the PRA Welfare Block Grant Had Been Adopted In FY 1988, Using FY 1987 Levels

(Dollars in Millions)

	FY 1993: Actual State Claims a/	Block Grant: 103 percent of FY 1987 level	Difference b/	Percent Change
Alabama	$12	$7	-$4	-38%
Alaska	6	1	-5	-83%
Arizona	26	7	-19	-72%
Arkansas	14	4	-10	-70%
California	545	186	-358	-66%
Colorado	26	11	-15	-58%
Connecticut	22	7	-14	-67%
Delaware	3	1	-1	-57%
Dist. of Col.	13	6	-7	-55%
Florida	67	18	-49	-74%
Georgia	36	17	-19	-52%
Hawaii	4	1	-4	-83%
Idaho	4	2	-3	-62%
Illinois	137	41	-96	-70%
Indiana	50	8	-43	-85%
Iowa	20	7	-13	-64%
Kansas	24	7	-17	-73%
Kentucky	42	12	-30	-72%
Louisiana	43	20	-23	-54%
Maine	14	6	-8	-55%
Maryland	51	19	-32	-62%
Massachusetts	69	9	-60	-88%
Michigan	136	76	-60	-44%
Minnesota	42	15	-27	-64%
Mississippi	9	5	-4	-46%
Missouri	40	21	-19	-48%
Montana	6	3	-4	-60%
Nebraska	13	5	-8	-60%
Nevada	5	1	-3	-68%
New Hampshire	9	2	-7	-76%
New Jersey	37	24	-13	-34%
New Mexico	10	5	-4	-44%

Hypothetical Impact in FY 1993 if a Child Welfare Block Grant Similar to the PRA Welfare Block Grant Had Been Adopted In FY 1988, Using FY 1987 Levels

(Dollars in Millions)

	FY 1993: Actual State Claims a/	Block Grant: 103 percent of FY 1987 level	Difference b/	Percent Change
New York	852	237	-615	-72%
North Carolina	28	10	-18	-66%
North Dakota	7	2	-5	-68%
Ohio	128	39	-89	-69%
Oklahoma	15	8	-7	-48%
Oregon	20	12	-9	-43%
Pennsylvania	200	55	-144	-72%
Rhode Island	14	5	-9	-63%
South Carolina	16	8	-8	-50%
South Dakota	4	2	-3	-61%
Tennessee	26	8	-18	-71%
Texas	105	36	-69	-66%
Utah	10	4	-6	-62%
Vermont	9	5	-5	-51%
Virginia	22	9	-13	-57%
Washington	28	9	-18	-66%
West Virginia	7	9	2	33%
Wisconsin	55	23	-32	-58%
Wyoming	2	0	-2	-86%
Territories	9	4	-4	-48%
U.S. TOTAL	$3,092	$1,039	-$2,053	-66%

NOTES:

Programs in the Hypothetical Block Grant Include Foster Care (Maintenence, Administration, and Training). Adoption Assistance (Maintenence, Administration and Training); and Title IV-B Child Welfare Services.

a/ Dollar amounts reflect state claims, adjusted for disallowances.

b/ May not add due to rounding.

Chairman JOHNSON. Thank you, Madam Secretary.

There certainly is a lot of common ground between us, and I am pleased that your testimony does recognize the difficulties of the current system and the degree to which valuable resources are steered into unproductive avenues. Certainly, to redefine a new partnership between the Federal Government and State government in regard to the management of moneys available for child welfare purposes is a challenge that I think we must not fail to meet and it is one that you are well prepared to work with us on and I believe we are well prepared and willing to work with you on.

I do regret your example of the impact on States of a capped block grant, starting with 1987, going back some years. First of all, no one, no one, no Republican has proposed capping spending without any regard for inflation or numbers or institutional care, no one. And I want the record and the audience to understand that. Because if we are going to work together fruitfully to make the very kinds of changes that interest you and that have long interested me, we have to be absolutely clear that we will destroy ourselves, this Congress and our form of government if we can't do politics a little better than that. And I am dead serious about this.

You will remember that I proposed a bill when Tom Downey and I were working on this very subject which would have capped spending in a way that, frankly, States would have more money now than they do because while it would have become a capped entitlement, every year the baseline would have risen for inflation and numbers of children and, frankly, at the time the States would have gotten both flexibility and money. So I just want it absolutely clear that no one is talking in those terms, that what we are talking about is looking at a system that has all too often looked at paper, not children's lives, that has thousands of State employees doing reports when they don't have time to tend to families. So that is our common ground and I am very pleased that your testimony so clearly delineates that common ground.

I want to start with a couple of questions and then I will yield to my colleagues and come back later for those that haven't been covered.

First of all, if we eliminate rigid Federal procedural requirements and reduce the paperwork burden and administrative costs necessary to comply, won't this free up significant resources that the States could use for services and won't it also free up resources in your own department, and have you done any analysis of what that impact would be on either your department or the States?

Ms. BANE. We have done some analyses and are obviously doing more, Madam Chairman.

I know that you have been concerned about the paperwork issue, and when I was commissioner in New York, caseworkers always yelled at me about paperwork. And I, when I was a commissioner, spent a fair amount of time with caseworkers, sitting with them, going through their days and so on to see what we could do about the paperwork. And as best I could tell, there were three types of paperwork that the caseworkers were complaining about.

The first had to do with doing case plans, that is, with writing up their notes, with writing up what they had done and what they

were planning for the children. And although I was sympathetic to the fact that we might be able to do our forms better and that we might be able to make it easier for them to do that paperwork, I was actually convinced that what they were calling paperwork really was an important part of service provision, an important part of dealing with families and children.

A second part of the paperwork that they complained the most about to me and that I observed them doing as I sat with them was the paperwork related to court appearances. It depended a lot on jurisdictions obviously, but caseworkers had to spend a fair amount of time preparing papers for courts and sitting in courts and going through those things, and again, it seemed to me that we could work on ways of doing that more effectively and efficiently. But again, the core of what they were doing was really quite important.

The third thing they complained about was the paperwork that was involved in meeting Federal requirements for eligibility determination and Federal requirements for reporting. That, frankly, was way down on their list of paperwork requirements. And again, we want to work on how to do those more effectively.

But my sense was that we needed to help caseworkers do their jobs more effectively but that it really wasn't in fact either the Federal protection requirements or our State regulations—they, by the way, saw it all as a State problem, not as a Federal problem, which I thought was interesting. We can certainly make some improvements, but it didn't look to me like it was a real large amount of resources.

Chairman JOHNSON. That is interesting, because the last time we held hearings on this subject when Mr. Downey was chairman of this subcommittee, we had testimony from socialworkers that they were using 80 percent of their time on paper with only 20 percent of their time for families. And while that may be an exaggeration, my own experience with the amount of time my own department has spent making reports to the Federal Government, arguing about reimbursement rates, fighting and negotiating, is simply extraordinary. And so I think we do need to find some way to get a more precise and honest understanding of the degree to which the mechanism has become the object. And if you care to submit later on any more precise information by looking at your department, what would happen, whose jobs would be affected, what resources would be freed up, we are at some point going to need that information. I know that is hard to do.

I remember specifically holding these kinds of hearings at the State level and being told afterward by some administrator, I couldn't possibly tell you that and run my department, too. So I understand there is some conflict of interest there.

But we are going to be able to determine that more accurately. Maybe not for our own bureaucracy. But for those kinds of reasons but certainly at other levels so that we can make a more honest determination about what kinds of moneys this will free up.

Ms. BANE. May I speak to that, Madam Chairman?

Chairman JOHNSON. Yes.

Ms. BANE. On the Federal level, we have slightly fewer than 100 Federal employees involved in the child welfare system. And you know, it is hard to make estimates, but the total administrative

budget for my agency is $164 million. I can't imagine that more than a quarter—and I suspect quite a lot less than that, is involved in the child welfare area. So that gives you some idea of the order of magnitude. The resources and personnel involved at the Federal level are a tiny fraction of the total work force in child welfare.

Chairman JOHNSON. Certainly, when you multiply it by the 50 States.

Last, let me just say if we do pursue a block grant of child welfare and foster care programs, what minimal standards would you recommend accompany those or would you like to get back to that subject? Perhaps you can talk about it generally and then in the course of events get back to that more specifically.

Ms. BANE. I think maybe I could talk generally now and then I hope that we will have opportunities to continue this conversation. It does seem to me that any approach to a Federal-State partnership would involve some Federal standards and Federal protections——

Chairman JOHNSON. Of course.

Ms. BANE [continuing]. To ensure the safety of children, to be sure they are oriented toward permanence and to assure they are looking out for the well-being of children. I would hope that we could formulate those more as results and outcomes for the system than as processes, though I think we will always have to have some procedure.

Chairman JOHNSON. Have you begun thinking about those?

Ms. BANE. We have. We have also been working with the States in ways that we are very excited about to try to see if we can't focus those protections more on outcomes and results.

I would also suspect that any approach to child welfare services would want accountability for Federal money to ensure that it was being spent for the purposes and for the children that the Federal money was meant to serve and, finally, that it was being used in very efficient ways. I think that we can work with you, we can work with the States to develop effective approaches in that regard.

[The following was subsequently received:]

In the last session, the Congress changed the section 427 dollars from incentive funds to an allocation based on State assurances that the essential protections were in place. This was a major step toward reducing the time spent in resolving disputes over disallowances. in the future, HHS plans to monitor the State's provision of the protections and to provide technical assistance in those instances where the protections are missing. The time spent documenting, negotiating, and appealing our fiscal decisions will be significantly reduced. That time will be used to develop corrective action plans and provide technical assistance.

Chairman JOHNSON. Thank you. And I will yield to my colleague, Mr. Matsui, from California.

Mr. MATSUI. Thank you, Madam Chairman.

In terms of the issue of flexibility, under current law, do you have the ability to waive requirements under child welfare programs IV–E, IV–B, and others?

Ms. BANE. Mr. Matsui, we don't have general authority to waive requirements as we do for the AFDC program. What we do have as a result of the legislation that was passed last summer is the authority to put in place 10 State demonstrations where we can waive many of the requirements of IV–B and IV–E. I am really excited about that. I think that is going to give us and the States the

opportunity to explore some really creative approaches, and I think that by having a limited number of them we can make sure that the demonstrations that do in fact take place will help us learn and will help children and families.

Mr. MATSUI. In fact, that is Chairwoman Johnson's suggestion, I think, in the legislation, her amendment.

Ms. BANE. I am delighted.

Mr. MATSUI. Let me ask you with respect to that program, obviously it was October I guess of last year so, the implementation is—you are working on that now, is that right?

Ms. BANE. That is correct.

Mr. MATSUI. And identifying some of the potential participants?

Ms. BANE. That is correct.

Mr. MATSUI. And without obviously being too specific, what areas are you looking at? I mean, where are some of the needs that need to be—or problems that need to be addressed?

Ms. BANE. Well, different States, I am sure, are going to come in with different kinds of approaches. I know that some States are looking at ways to have some flexibility in the funding stream so that they can give the agencies that actually deal with children a wider range of approaches. And I think that is the thing that we are going to be looking at, ways that the States can figure out how to use the total amount of funds that are available to them in more creative ways.

Mr. MATSUI. I would imagine some of the administrative cost issues will come up in this as well; is that right? In other words, how you can reduce costs and use the dollars more efficiently.

Ms. BANE. I assume so.

Mr. MATSUI. Let me ask you, last, about the paperwork issue, because obviously that is one that will be discussed more and more, I believe.

I have reviewed the court system in California. I visited our juvenile court system a number of times and have even been to Los Angeles and talked to some of the judges there over the years. And obviously the paperwork involved when the caseworker presents the case—not presents the case, but when the attorney as guardian presents the case, they have to have the backup information.

In your role as commissioner, I guess in New York and also here as the Assistant Secretary, is there some way to find efficiency? Because that seems to be the largest paperwork burden, if you want to call it that, that the caseworker has. We need—they need to make sure the record is complete. They need to make sure their allegations, whatever they may be, are complete.

Ms. BANE. I think the trick here, Mr. Matsui, is to try to distinguish the necessary, useful, and helpful paperwork from the paperwork that we can try to streamline. I believe that using case planning tools and service provision tools is really very important, and that it is important to have written records of contacts with children because caseworkers turn over and need to be able to share with other caseworkers that work.

I do think, though, that we can streamline the process. The family preservation and support legislation that was passed a year ago last summer included some funds and a mandate for grants to the States to try to improve and streamline their court systems. And

again, I think this is a very exciting opportunity for us to see what we can do.

Mr. MATSUI. The reason I asked this line of questioning is because I think what you say, the turnover issue, you see, is a pretty difficult issue to deal with. I mean, it sounds easy when you are sitting here, well, you don't need much paperwork. But the caseworker may change.

I think it was 4 or 5 years ago, the medical records of young children in the foster care system were not transferred from placement to placement. That was a big fight. I think the advocacy groups were very helpful. I didn't even realize medical records weren't transferred with the child. But when the child goes from State to State, five to six foster care families over a 5- to 10-year period, those records don't usually go with the child, or education records. And so you need—you need to make sure that there is an adequate paper trail behind that child because the child usually doesn't have one custodian.

My child—our only son or only child, 22 years old, my wife and I know everything about him. We think we do. We don't anymore but we used to. But the fact is if that child were in the foster care system when he was 2 years old, I don't think anybody would really understand that child's history. And I think we need to make sure we understand that.

So when we complain about paperwork and the bureaucracy, there is another element to it. These kids need a file because most people won't be with that child for an indefinite period of time.

I have no further questions.

Chairman JOHNSON. Thank you and I will recognize now Mr. Hancock.

Mr. HANCOCK. There is just one question that I would like for you to explain for me on page 3 of your testimony. You state that 20 percent of the States have found that State systems violate the constitutional rights of children. Would you define exactly what you mean by "constitutional rights of children" in your testimony?

Ms. BANE. I believe that in most of the cases, they were findings that related to State statute rather than necessarily to the Constitution, though I think there were some equal protection claims explored in some of the cases. In many of the cases, the finding of the court was that the system, the child welfare system, was failing to provide basic physical care, safe care to the children in custody of the State.

Mr. HANCOCK. But you are defining that as a statutorial right rather than a constitutional right.

Ms. BANE. As I say, in some of the cases it was done on statutory grounds, in others it was done on equal protection grounds, and in some it was done on State constitutional grounds. We can get you——

Mr. HANCOCK. Primarily under the equal protection law, the equal protection of the——

Ms. BANE. Mostly under the due process clause, I am told.

Mr. HANCOCK. Under which?

Ms. BANE. Under the due process clause, that is, the children and their families weren't afforded due process. We can get you an analysis, if that would be helpful.

Mr. HANCOCK. I would like to have more information on that, the determination of your department of just what constitutes constitutional rights. I would appreciate it if you would get me some information on that.

Ms. BANE. We certainly will. These were, of course, court determinations, not ours.

Mr. HANCOCK. Thank you, Miss Chairwoman. Thank you.

[The following was subsequently received:]

Litigations have been brought by advocates for children based on State law, Federal law, and the U.S. Constitution. The constitutional grounds have been based on substantive due process rights—specifically the right to freedom from harm while in State custody.

Chairman JOHNSON. Mr. Herger.

Mr. HERGER. Thank you very much, Madam Chair. And it is good to have you with us, Secretary Bane.

My question, you state in your written testimony that Federal funding for child welfare increased by 300 percent since 1987, yet I see on page 5—and I believe you mentioned in your oral testimony the reports of child abuse and neglect increased only 25 percent and foster care placement increased by only 50 percent, indicating that factors other than increase in caseload have resulted in increased Federal spending.

What, in your opinion, were these other factors, the difference between the 300 percent and——

Ms. BANE. Mr. Herger, I think there were a number of things going on and I actually don't think we understand them all fully and we do need to understand them better.

Caseloads were going up. The difficulty and complexity of the cases also appeared to have been going up in many, many States. Madam Chairman mentioned the increase in crack cocaine, along with the increase in the number of children who were coming into the system as infants. So it was not only the increase in caseload but the increase in the complexity of the caseload.

A second thing that was going on was that States were involved in trying to improve the quality of their child welfare systems. They were trying to improve their preplacement services. They were trying to improve their case management services, and they were able to claim Federal funds for that, quite rightly.

A third thing that was going on—and I know this has been a topic of some concern, is that the States were taking advantage of the opportunities in Federal law to claim Federal funding for many of their costs, quite legitimately, I must say.

One thing I think a lot of people don't realize is that the Federal Government funds only about 40 percent of the child welfare system and the child welfare services in this country. And as the Federal spending was increasing, I know for a fact for New York, and I assume this is true in other places as well, that State spending was also going up a lot. So both the States and the Federal Government were responding, I believe, to a tremendous increase in need, as well as an impetus to try to improve the services that they were offering to children and families.

Mr. HERGER. You also state that States and communities should not be hamstrung by narrow categorical programs and rigid funding streams. Specifically, could you tell us what programs and

funding streams you consider too narrow? Which ones you would recommend to be combined?

Ms. BANE. I don't think I am in a position at this point to make any specific recommendations to you. I know that many people are proposing that we look at a number of the programs that deal with child welfare to see if there can't be some flexibility, and as I said to Mr. Matsui, I think the opportunity that is afforded us by the demonstration authority last summer will allow us to work with the States to identify those places where flexibility will be the most useful and helpful in improving the system.

Mr. HERGER. OK. Thank you.

Chairman JOHNSON. Thank you. I would like to emphasize, though, that being more specific about rigid funding streams and narrow categorical programs now is really important, because as important as those demonstration projects were—and I fought many years to get them in line, they will take awhile to put in place. It will be awhile before we understand them.

I don't know whether the teen suicide prevention money is still a separate line item, but that is exactly the kind of thing that is driving my agencies absolutely crazy, because it prevents a holistic approach to family problems. So we really do want to make sure that as we make change, we address some of the very specific needs.

I also would want to point out in followup to Mr. Herger's comment about the chart and about claims, there is a big difference between claims made and claims received, as you in New York know very well. I think your difference one year was $178 million. And your chart does deal with claims made. And that is a problem that I have with it and I would hope that the information that we pass between your department and this committee or other subcommittees of Ways and Means will be a little bit more realistic, because I think it will enable us to work together more fruitfully.

Ms. BANE. I think we did take account of disallowed claims. I will check on that for you and get back.

Chairman JOHNSON. Do check on that. Because the way it is worded both in your testimony and on the chart, it implies that that is not the case.

Ms. BANE. I think we did take account of that. You are quite right that we need to.

Chairman JOHNSON. Thank you.

[The following was subsequently received:]

The answer is correct. We did take into account the claims which were disallowed.

Chairman JOHNSON. Mr. Levin, please.

Mr. LEVIN. Thank you.

Let me pick up on the discussion about the chart, because I think the Chairwoman's discussion provides some ray of hope that we can find some common ground. And I would like to talk to you about the general underpinnings of this discussion. The last couple of weeks, Nancy, actually there have been some proposals to block grant at a set level without regard to inflation or caseload. That came up in the AFDC discussion.

Chairman JOHNSON. If the gentleman would yield. I don't think it has been clear in those discussions exactly what the block grant

cap would be tied to because there is no agreement yet on that issue and there certainly is no legislative language.

Mr. LEVIN. No. Governors were asked whether they would be willing essentially to take the provision in the Contract which is 103 percent of the total amount for each fiscal year for the next 5 years. The response from several Governors was that they would take that bargain, and a number of our colleagues indicated that a block grant might look like that.

And I am very much in favor of much, much more State flexibility. I would have us move to a different kind of Federal-State relationship. But the question is whether there will be any Federal role whatsoever, whether there is room for a Federal role, whether we want to essentially partnership or we want total State responsibility with the only State-Federal function being funding, which eventually might be phased out and replaced with a lower rate of taxation federally and let the States pick that up. That is the consequence, I think, of one position, just block grant it at an absolutely straight level.

So your resistance to that idea I find encouraging, though others have said the block grant might look like that. So I want to ask you——

Chairman JOHNSON. I am merely pointing out in the technical language of the Contract bill, the capped entitlement is adjusted both for numbers and inflation. While there have been conversations with the government, there is no proposal on the table that doesn't allow significant adjustment.

Mr. LEVIN. Well, let me just read to you the option in the Contract. It says in lieu of any payment under any other subsection—this is AFDC—the Secretary shall name payments to the State under this subsection for each fiscal year in an amount equal to 103 percent of the total amount to which the State was entitled under this section for fiscal year 1992. And what this chart said, and a similar chart was presented at the hearing on AFDC, if that system had been in existence in 1988, this would have been the impact in the year 1993. That is what it says.

Now, I am trying to agree with you in your resistance to that idea. I just think it is not fair to say that no one has proposed this approach. And what I am in favor of is a very candid, forthright discussion of Federal-State relationships in AFDC and in the child welfare area.

As someone who for years has been in favor of much more State flexibility, the question is whether you are going to take it to the point where several Governors and others who testified a few weeks ago want to go, that is, the only Federal function is to get out of the way. And I asked the Secretary this question about AFDC last week so I won't ask you the same question here. Because in your testimony, you say—I will quote just a couple portions:

On page 3, the need for State flexibility with the Federal role—excuse me, of ensuring accountability for high-quality outcomes for children and families. And then on page 3, "I believe the Federal Government has a very important role in bringing about changes in these systems." And then on the last page, you suggest "an approach to change that balances flexibility for States and commu-

nities with the need for a national framework, accountability for outcomes, and effective protections for children and families."

So I think this is the question and you bring the experience not only of your role here but your role in New York. Why should the Federal Government be involved at all except perhaps to be a continuing funding source until perhaps that is phased out? But why should there be any balance at all?

Ms. BANE. Mr. Levin, I think the best way to respond to that question may be to think back to the situations in the States that generated the impetus for the Adoption Assistance and Child Welfare Act of 1980.

That act was developed and passed by Congress because of pretty terrible things that were going on in the States and that were coming into public view. I think that act was generated and passed because many States didn't have the capacity to deal with the needs that were being generated by their children and families and the sense that we, indeed, did have a national duty to the children that were involved.

And I think that legislation, although it has not been implemented perfectly and I don't want to defend everything about that legislation, I think the concepts and the ideas behind that legislation—to ensure children were being dealt with in ways that ensured their safety, that State systems were focused on permanence, not on letting kids drift around from one foster care home to another, and that States were pushed to put in place a continuum of services so that they could deal with the needs of families and children—I think that legislation had big effects and I think that we still need that kind of national commitment and national help to the States.

Mr. LEVIN. And you think we still need it because?

Ms. BANE. Because I think the children and families are still in trouble. Because I think the States vary enormously in their capacity for dealing with these problems, and to some extent, in their will for dealing with these problems. And so I think that both national leadership and national funding is real important.

I also think, Mr. Levin, that the States are not in a position each and every time to create everything anew. I think there is a very important role for helping to provide some experience, some information, some national leadership in these really important areas.

Mr. LEVIN. Thank you.

Chairman JOHNSON. I do want to just clarify for the record, Mr. Levin's statement about the 103-percent increase, because the Contract bill has not been widely read. The Contract bill does block grant a lot of programs together, and allows that capped entitlement to grow and accommodate for both inflation and numbers.

There is within the Contract bill an option for States to completely take over just their AFDC program. It is for those States that completely take over their program, remember, thus freeing themselves from all Federal constraints, that would be subject to the 103 percent, the theory being that if they were running this program themselves much more flexibly—in a way that got women into the work force in a much more flexible fashion, that being guaranteed that their grant would grow by 3 percent was really

quite generous, if in fact they were able to do the better job than they say they are able to do.

So the 103 percent does not honestly quote what the bill does in regard to its larger capped entitlement approach, which it does allow to grow for both numbers and for inflation. So I wanted to get that clearly on the record. And I will then——

Mr. LEVIN. Will the gentlelady yield just for 1 second?

Chairman JOHNSON. Yes.

Mr. LEVIN. So there is no misunderstanding, I read and said it was an option. But——

Chairman JOHNSON. It is also in regard to only one program, AFDC.

Mr. LEVIN. That is true, that is true. But in fairness to what went on the last couple of weeks here, this issue of converting to a block grant at a set figure became the focal point of discussion on welfare reform. And a number of people expressed a belief that the option that is in the Contract might well become the model for block granting. And some concerns were expressed, some questions were raised by myself and others, including the issue of what is the national interest.

And so I think it is accurate to say that in the last several weeks we have had a discussion during which one idea has been to essentially turn the option in the Contract into a basic approach for block granting. And I—I am encouraged by your statement that as we look at block granting, we need to look at issues like inflation, like caseload, like needs.

Chairman JOHNSON. I certainly appreciate your concern with how block grants would have to be adjusted in the future. And I also certainly recognize the vitality of the discussion that is going on between the Governors and members of the Human Resources Subcommittee. But I did want to make clear that in the Republican proposal, in the Contract, which is far more conservative, if you will, than the Republican proposal approved by the Republican Conference, that even in that proposal there is no provision for freezing. And that is what the chart that has been presented to us is based on, and I regret that very much.

But I also wanted to make clear that even in that narrow portion of the bill that uses the 103 percent, that is only the part of the bill where the States get to opt, if they choose, to completely take over their AFDC program. So I wanted that clear.

I also want to make clear that in no form of any bill has anyone proposed capping foster care maintenance payments, which of course are the largest dollar amounts of the Federal contributions to the child support programs that we are discussing here today.

Mr. LEVIN. We will be discussing that. If you look at the capping provision in the Contract, it doesn't take into account a number of the factors that you have referred to. It talks about the change in the poverty population. But my point was not to be critical of what you said, but to be encouraged by it, and to say that I think the chart that was presented by HHS does have some relevance and to suggest, further, that as we look at this whole issue of a reworked State-Federal relationship, that we keep in mind what was testified to in the last few weeks.

Thank you.

Chairman JOHNSON. Thank you, Mr. Levin.

Mr. Zimmer.

Mr. ZIMMER. Thank you, Madam Chairwoman. I think that the discussion that has gone on between you and Mr. Levin is very helpful. It may seem technical, may seem abstruse, but it is important that we discuss policy initiatives on the common basis of fact. And I think we are struggling toward that common basis of fact. I don't think we have reached closure on that.

But there is no way we are going to have a useful policy discussion if we continue to deal with strawmen and misleading and sometimes downright phony figures and assumptions. Along that line, I would like to go back to the chart that you presented us.

You used a defined period from 1988 to 1993 as the base for your chart, and could it not be that that time period, which was a period of enormous growth in title IV–E, administrative costs, would distort the picture?

As I understand it, the growth in the title IV–E administrative costs program in the late eighties and the early nineties was due to the fact that the States were aggressively pursuing claims for IV–E administrative cost matching funds for preventive services that should have been covered by IV–B, child welfare program funds.

Ms. BANE. Let me just speak of the chart for 1 minute, and then try to speak to that again.

We did about, I don't know, 25 versions of this chart, you will not be surprised to learn. And my advisers said that we could only submit one with the testimony or it would be too confusing. We picked this one for the reason that Mr. Levin noted, that it was analogous to the one we had presented on AFDC 1 week ago, and the one on AFDC we built from the block grant provision in the Contract bill. Obviously there are many other ways.

We did do one that adjusted for inflation. The State patterns looked the same. It shows in aggregate that the States would have been only 40 percent worse off than they would have been, instead of 60 percent worse off, but shows the same kind of things.

We would be happy to do any other analyses that would be useful for you. In terms of your question, the 1988–93 period was indeed a period of great growth in the foster care caseloads. In the AFDC caseloads it was also a time of growth.

Again, if I might speak back to my experience in New York on this, I was worried about these programs in 1987; I was working in New York at that time. At that point, we were enormously relieved that the foster care caseload and our foster care spending had finally leveled off, and believed that we were actually in a quite good position to face the future.

So I think if I go back and put myself in that position in 1988, I did not in fact predict what was going to happen between 1988 and 1993. I think the thing to keep in mind as we do any of these simulations or look at these is that it really is very hard to predict what is going to happen, and all that says is, let's just be real careful as we try to think about how to construct these.

Mr. ZIMMER. I am all in favor of being careful, but I think we ought to deal from the top of the deck.

Isn't it true that one of the underlying purposes of the Family Preservation Act of 1992 was to restrict the rate of growth of title IV–E administrative costs?

Ms. BANE. The hope of the family preservation and family support approach was that by the provision of services to families before and during placement, States could develop a system in which there would be less need for out-of-home placement, and that there might, as a result, therefore, be less need for maintenance payments in the foster care system and payments to institutions.

I think that there was also some hope that family preservation and support would contribute to the services that the States were able to provide. I don't remember it being specifically focused on administrative costs, but I could be——

Mr. ZIMMER. Well, isn't it a historical fact that there has been a leveling off of the rate of growth of the IV–E administrative costs program in the last few years?

Ms. BANE. Actually, what is interesting about that is that—we looked at it State by State. And what happens is that for each State, there tends to be a 2- to 3-year period where what they are claiming under the preplacement administrative and services piece, that is, the nonmaintenance piece goes up very sharply. And that is the period at which they are expanding their system or realizing that they can get more Federal money. And you see that, and then it does level off.

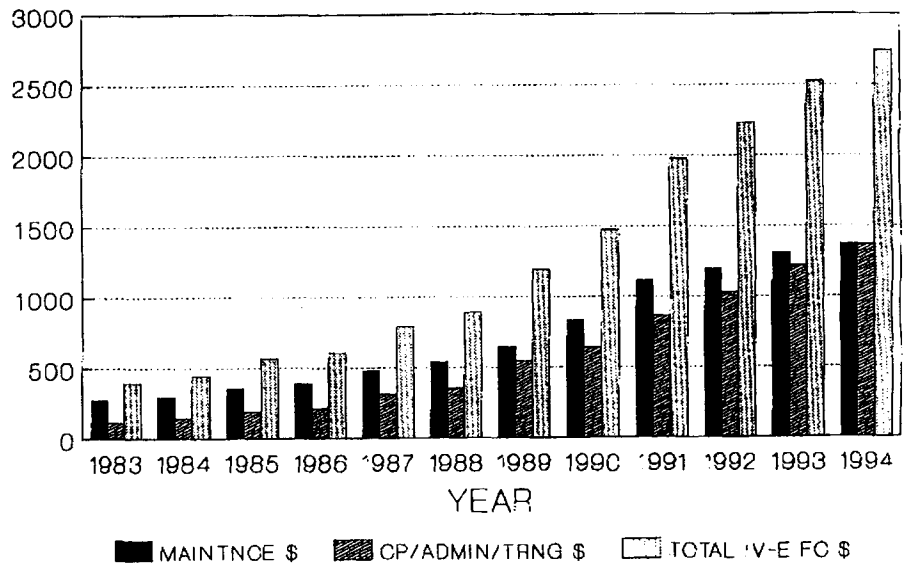
Not all the States have been through that period, however. Not all the States are yet at a point with their child welfare systems where they are taking full advantage of the opportunities they have for Federal participation. So I frankly would continue to anticipate some growth, although perhaps in the future we will see some leveling off.

Mr. ZIMMER. Nationally, since the passage of the 1992 act, has there been a leveling off?

Ms. BANE. I am sorry. We have a chart which I should probably submit for the record, rather than trying to show it to you. It shows continuing growth since 1992 in the nonmaintenance piece, and also continuing growth in the maintenance piece. It is not quite as sharp as in some of the earlier years. I think also, though, that although the Family Preservation and Family Support Act was passed in 1992, the first year was basically a planning year. So we haven't seen any results from that act yet reflected in the operation of State systems or in their claims.

[The following was subsequently received:]

IV-E FC COST ANALYSIS
FROM 1983 TO 1994



CP = CHILD PLACEMENT

TITLE IV-E FOSTER CARE

Funds can be used for:

Payments (FMAP): **Benefits paid on behalf of the child to a foster parent or institution.**

Child Placement Services and Administration (50% FFP):

- **Recruiting foster homes**
- **Licensing foster homes**
- **Preplacement activities:**
  (prior to a child being placed in foster care)
  - **Placing child in home**
  - **Preparing case plan**
- **During placement–Case management activities:**
  - **revising case plan**
  - **preparing for and appearing in court**
  - **arranging for and getting child treatment services**
  - **working with child's parents and foster parents on current and planned future steps and problems**
- **Computer systems (75% FFP enhanced match is available through FY 1996)**
- **Normal Administration**

Training (75% FFP): **State agency staff–related to Title IV-E**
Foster parents and adoptive parents
Member of State-staffed or State-approved institutions

Mr. ZIMMER. So that ought to make an even stronger case for the fact that we ought to expect the growth to be slower in the future, if it hasn't had its full impact yet.

Ms. BANE. Oh, I hope and pray the growth will be slower.

Mr. ZIMMER. So it is very difficult to make predictions on the basis of extrapolation?

Ms. BANE. That is correct.

Mr. ZIMMER. But do you really believe that we are going to see growth in the future at the same rate that we saw it between 1988 and 1993?

Ms. BANE. As I say, I hope and pray that we won't.

Mr. ZIMMER. Do you expect that we won't or do you expect we will?

Ms. BANE. I think we are going to continue——

Mr. ZIMMER. You are the professional here.

Ms. BANE. I know. As I say, I am thinking back to sitting in front of a New York State Legislature in 1988 and confidently predicting that foster care and child welfare expenditures were going to level off, and being proved wrong. So I have become slightly more cautious about making predictions.

As I say, we hope that it will level off. We hope that States will be able to make the improvements that will bring it about. But I am going to be cautious about making predictions.

Mr. ZIMMER. Well, obviously you should be cautious, but I think there is good reason not to use the worst-case time period, with the period of steepest growth, to predict the terrible catastrophe that would happen if there was a freeze of the sort that we have already learned was not proposed.

Thank you very much.

Thank you, Madam Chairman.

Chairman JOHNSON. Thank you, Mr. Zimmer.

We will go now to Mr. Johnson.

Mr. JOHNSON OF TEXAS. Thank you, Madam Chairman.

I have been told that child welfare block grants to States, or grants that are made to States at this time, that we authorize 75-percent Federal matching grants, and according to our information, they are distributed to the States on the basis of their under-21 population and per capita income. Is that correct?

Ms. BANE. That is correct, as it——

Mr. JOHNSON OF TEXAS. Well, I am also told that the reporting requirements are minimal, and there are absolutely no reliable national or State-by-State data on the exact number of children served, their characteristics or the services provided. Furthermore, that there are no Federal income eligibility requirements. Is that true?

Ms. BANE. It is partly true and it is partly not true. The formula to which you refer is the formula by which $300 million in IV–B child welfare money is distributed to the States.

Mr. JOHNSON OF TEXAS. Last year I was told $294 million. Is that right?

Ms. BANE. Yes, that is correct, $294 million.

Mr. JOHNSON OF TEXAS. Let's use real numbers. That is what Mr. Zimmer was talking about.

Ms. BANE. I just was rounding up.

Mr. JOHNSON OF TEXAS. There is a lot of difference between 294 and 300.

Ms. BANE. Thank you.

Mr. JOHNSON OF TEXAS. Go ahead.

Ms. BANE. I am sorry, reporting requirements. It actually has been the case, Mr. Johnson, that we have had very little and not very good information about child welfare systems in the States and about the effectiveness of programs. That is one of the reasons that Congress both required a new reporting system and authorized funding to the States for computerized systems, so that they would be able to do a better job of managing their child welfare systems. All the States now are engaged in computerizing their systems and developing an automated case management approach, and in using those automated systems to meet not only their own but Federal reporting requirements.

So we are coming to be in a position where we will have a lot more information and States will be able to manage their programs much better, because of automation.

Mr. JOHNSON OF TEXAS. Well, I am not sure computerizing is the absolute answer, because you don't always get good input. But concerning section 427, do you favor forgiving States who fail those past reviews?

Ms. BANE. We are actually very pleased that Congress last summer made changes in the legislation so that we would have a more flexible approach for working with States. What you passed last summer allows us to develop corrective action plans with the States, to do periodic reviews and to make sure that any penalty that we assess is commensurate with the degree of failure. And I think that is a more sensible approach than the all-or-nothing approach that was in the earlier legislation.

Mr. JOHNSON OF TEXAS. Well, are you assessing penalties on the States now?

Ms. BANE. We are assessing a set of penalties now for failures which took place in a previous period.

As you know, Congress put a moratorium on our taking disallowances for a couple of years, but last October removed the moratorium. We were told that those disallowances now constitute debts to the Federal Government, which we are required under prudent financial management to collect. And we are proceeding to collect those debts which have been firmly established as being owed. We are trying to do very carefully what the law requires.

Mr. JOHNSON OF TEXAS. So what you are saying is, you are punishing the States and the kids because there is not going to be that money there for them. And you are answering my question that you are not forgiving the States for past reviews.

Ms. BANE. We are not forgiving the States for the past debts that were incurred as a result of those reviews. As I say, our legal analysis is that the law required us to do this.

Mr. JOHNSON OF TEXAS. So you are punishing the States and punishing the kids. That is all I wanted to know.

Thank you, Madam Chairman.

Chairman JOHNSON. Mr. McDermott.

Mr. MCDERMOTT. Thank you, Madam Chair.

Dr. Bane, we appreciate your coming up here and testifying. You share with us, I think, the same difficulty; that is, it is very hard to come up and react to legislation by press release, because there is nothing on paper.

I know why you had to do 25 charts. We hope there is going to be some kind of bill available on February 6 when they start to mark up welfare reform, so we can actually look at some real figures.

But I am mindful of your history, and I thought of George Santayana, who said those who fail to learn from history are doomed to repeat it. And my own career was 15 years in the State legislature before I got to Congress.

Where were you from 1980 to 1985? What was your professional responsibility at that point?

Ms. BANE. That is a good question. From 1980 to 1983, I was at the Kennedy School of Government being an academic; from 1984 to 1987, I was at the New York State Department of Social Services as the number two person.

Mr. MCDERMOTT. OK, good, that is what I want to know.

I was down at the State level as ways and means chairman in the State legislature the last time this government went through the block grant business. We called it "block and chop," because when they blocked, they always chopped off some. And we always wound up with less.

Can you talk a little bit about the history of why the Federal Government first got involved in welfare. Mr. Levin's question prompted you a little bit, but the Federal Government didn't run out there to get involved in the States' business because the States were doing it so well?

Ms. BANE. I believe that is correct, yes.

Mr. MCDERMOTT. I would like to hear a little of the history, so that people understand that we have been through this block and chop business, and anybody who thinks this is going to be just block and not chop simply doesn't understand what the history has been in the past.

Ms. BANE. Right, right. I assume you are referring, Mr. McDermott, to the block granting of the social services block grant and the community services block grant in the early eighties. There were virtually no requirements, including, unfortunately, no reporting requirements, so we have very little information on what actually happened as a result of those.

But it was certainly very clear to us in New York during the period of the eighties that we were spending a good deal more of our State money for those purposes, especially for the purposes that were pulled together under the social services block grant, having to do with day care and child welfare and so on; and that at least from that one State's point of view at that one time, it did seem like the Federal Government was pulling back pretty badly.

Mr. MCDERMOTT. Let me ask you another question, because it seems to me that one of the things that our discussion about various programs is that we act as though they are sort of sitting out there all alone by themselves, not connected to anything else on the horizon. But I really look at this as kind of like a spider web. If you touch it in one place, it moves everywhere.

There is a proposal on the Hill here to reduce or to kick people off AFDC and to do a number of things in that area. Are you willing to talk a little bit about what you think will happen to the child welfare caseloads if you knock all the kids off the AFDC rolls?

Ms. BANE. Well, we all hope that reform of the welfare system will be done in such a way that children will be protected, that there will be a focus on work and parental responsibility and that children will be able to remain with their families and remain in good situations. I think many of us worry that some of the proposals being talked about—and again, I know that the committee has not agreed on a proposal, but that some of the proposals being talked about would indeed deprive AFDC benefits to large numbers of children for pretty long periods of time. And I think we all worry that under those circumstances, there would be more children who come under the child welfare system and come into the custody of the State.

And I think that as we think about that kind of a situation, we really want to be careful because the child welfare system is already terribly strained. It is already struggling with the needs of vulnerable children and families. To soon have to deal with more children, because their families are poorer because their mom can't get a job, seems to us to be a terrible mistake.

Mr. MCDERMOTT. Would you tell me about the turnover rate of your caseworkers? I know this is hard maybe, to remember back, but what was your caseworker turnover rate at the lowest level; that is, the entryworkers who are dealing with welfare cases and with child welfare cases and child abuse and CPS, those various programs?

Ms. BANE. Oh, in general, it was very high. Child protective workers probably had the highest turnover rate; they probably turned over every 2 or 3 years. I think they may have the hardest job that we ask anybody to do in this country, and we pay them terribly and we blame them when anything goes wrong. So I could understand why.

It was a tragedy, though, because, you know, the most important part of this system is a concerned caseworker who is able to make good decisions for children, and I think the extent to which we can put some investment into training for caseworkers, into support for caseworkers, into making their lives easier, is really going to pay off.

Mr. MCDERMOTT. Are you talking about 2 to 3 years as an average, or are you talking, the longest anybody lasted at it?

Ms. BANE. I think it was probably an average. It varied from State to State. It depended on whether there were any alternative employment opportunities as well.

Mr. MCDERMOTT. My experience is that that is true. I think it needs to be emphasized that paperwork, it is easy to rail against paperwork, but when cases are turning over rapidly, from caseworker to caseworker to caseworker every 2 or 3 years, if there is not an adequately done record, there is no way anybody can deal with these.

I, in my professional life, dealt with these cases in court and reviewed records of kids who had been in foster care for 10 years. And it was very often almost impossible to put together what had

actually happened to that kid because people had not recorded what the reasons were why he left one foster placement to go to another foster placement, how he failed, where he succeeded, and all those kinds of issues that are absolutely critical to making any kind of sensible judgment for a kid.

And I think that people need to understand, the paperwork isn't just something you say to people, well, sit over there and write a bunch of stuff down. It really is for the next person who is coming in in a couple of years, who has no idea where this kid came from and is usually handed it in a critical situation when the child's situation has all fallen to pieces. It comes back up on somebody's desk and they go to the file and it is 3 or 4 inches thick, and there is still stuff left out. I think that it is really important to say that.

I appreciate your testimony. Thank you. We will talk to you some more.

Chairman JOHNSON. Thank you, Mr. McDermott.

Mr. Portman.

Mr. PORTMAN. Thank you, Madam Chairwoman. I thank you for your testimony. This has been a very interesting discussion, wide ranging. I appreciate Mr. Levin's candid and forthright assessment of the Federalism issues here. I think that is exactly what is at stake, and I would like to pursue that a little further, and just make a couple of comments.

One, I think it needs to be underlined that part of what we are discussing as a Congress this year is the reality that being $4.7 trillion in debt and having a general consensus that we need to reduce our spending, I think on both sides of the aisle, and specifically facing a likely balanced budget amendment within 7 years, that there will naturally be cuts in all programs, all services on the Federal level, if we are to achieve those very significant cuts, and that the block grant program is in part a response to that.

We have been hearing from members of State legislatures, as Mr. McDermott was and many others on this panel, from Governors and so on, that they would prefer the block grant approach. Part of the reason they are saying that is, they want to keep current services and it is the Federal requirements and the paperwork and so on which takes an increasingly large part of the—of the dollar that they are able to provide for services. And what we are saying here in Congress and what they are saying to us is that there may be a better way to do this, a way to have current services maintained with the Federal budget imperative, which is to cut our spending here, and one way to do that might be to increase flexibility through block grants.

So that has a larger context that I think maybe hasn't been discussed adequately this morning.

I think Mr. Levin is right on target that this is really a much larger issue than just child welfare or just AFDC, and it goes to the role of the States and Federal Government. And maybe at some point we do have a shift back, in a sense reversing the trend of the last century of increasing Federal responsibility, back to more State responsibility.

In that context, I would ask you, we have learned about what you did between 1980 and 1985, but how long have you been in-

volved in child welfare programs in one way or another, either as an academic or as a person involved directly with programs?

Ms. BANE. Oh, longer than I am willing to admit. I don't know, 15 years, 20 years.

Mr. PORTMAN. In those 15 years, you have then seen how the States handle child welfare caseload, foster children, adoptions, and so on; you have seen how the Federal Government has reacted; you followed the developments Mr. McDermott pointed out where we have gone to block grants and back from block grants.

Would you say, in your judgment, that the States are doing a better or a worse job in that decade or two, in terms of providing child welfare services?

Ms. BANE. I am not sure I can speak for all the States. I mean, my perception certainly is that New York is doing a better job now than it was 10 or 15 years ago in providing child welfare services. And it also appears as though the 1980 legislation was a prod, if you will, to the States to make some improvements in their child welfare system; and most especially, to focus more on achieving permanent outcomes for children. That was really the focus of the legislation and the issue that was very much before people.

And I think that we have seen since that time in virtually all the States an improvement in the system so that the States are indeed keeping track of the children in their system, that they are in fact doing some planning aimed at permanence and really trying to achieve that.

Mr. PORTMAN. Is it your view that if we were to change the requirements at the Federal level, vis-a-vis New York State, as an example which you referred to, that New York State would shift back to less permanent solutions? In other words, is it necessary to have the Federal gun, so to speak, at the head of the States, in order to keep them on what you and I think most child welfare experts would agree is a proper course?

Ms. BANE. I think it is very hard to make a prediction about that. My sense is that some States would and some States wouldn't, and that in many States—and I think it would be fair to say that this was true in New York at some points in its history, too—that the fact that there are Federal guidelines and that there is Federal money was an incentive for the State to keep moving in the right direction.

I think it is also fair to say, though, that there are many other States where it appears that it really was the existence of the Federal legislation and it really was the existence of the Federal push that led to some improvements in the system.

Mr. PORTMAN. Earlier you mentioned that we don't have all the answers here in Washington, and I think, given your oral statement, you have a proper attitude with regard to flexibility, that the States are important laboratories of experimentation and that maybe there is a certain advantage to giving States that flexibility beyond all the budget issues we discussed, which is to say that they have got some pilot programs and some ideas that we haven't thought of.

Wouldn't you see that as an advantage to a block grant type program?

Ms. BANE. Oh, absolutely, it seems to me that State flexibility and State creativity are very important; and States have most of the responsibility for the child welfare program even now. I think that we can assess how we deal with the States, I think we can assess our accountability mechanisms. I think that we need to make some dramatic improvements there because our accountability mechanisms need to be oriented to results and they need to be oriented toward genuinely improving performance. There is no question about that.

And as I say, I think the ability of the States to try some things out is really very important. I guess we are all trying to struggle with this question of the proper balance between State flexibility and national leadership. That is the crux of the question that we are going to be going back and forth on as we have this conversation.

Mr. PORTMAN. If I could close, Madam Chairwoman, with one specific question along those lines—and I realize that there are lots of different specific proposals we are going to be hearing about over the next several months, but one in particular would be the separate program for abandoned infants for adoption opportunities.

Does that make sense, to have a separate program for that, or wouldn't it make more sense to block grant that program and give it to the States specifically to give them the flexibility you are talking about?

Ms. BANE. Those are two programs for adoption opportunities and abandoned infants. I think the discretionary grants that have been given under that program have allowed some very interesting things to go on that we have learned from. I think that they have done some good services. I think that may be one you want to look at.

Mr. PORTMAN. Thank you, Madam Chairwoman.

Chairman JOHNSON. Thank you, Mr. Portman.

And thank you very much, Secretary Bane, for your comments.

The Ways and Means Committee has always operated through legislation that has been introduced, reviewed at hearings, and then the chairman submits a mark that reflects not only the legislation that has been introduced and the concerns that it has raised but the input of the hearings. We are not, we never have and we don't intend to legislate by press release. We are proceeding as we always have through the submission of substantive, thoughtful proposals.

Fundamentally, the proposals that we are considering are going in exactly the same direction that your department is considering going; that is, toward reevaluating and rebalancing the relationship between Federal direction and State authority, assuring that together we carry out our responsibilities to the children of America.

There is, however, a sense of urgency; there is no question about that. Whether you vote for the balanced budget amendment or whether you don't vote for the balanced budget amendment, no nation can continue to spend more than it collects decade after decade. So we are now going to take our responsibility seriously, to bring these things back into line. We have given ourselves a time-

frame of 7 years, which is better than our normal 5-year view in this place.

And so there is a sense of urgency, and we are going to need your help and your sharp focus on the issue of, what programs can be appropriately brought together? How can they be governed in a way from Washington that we assure that children's interests will be addressed? How can we move the issue of accountability away from reports and toward the kind of data that we see not only in the private business sector but in the private human service sector doing a far better job of dealing with the issue of accountability and effectiveness than our old way of many, many levels of bureaucratic entanglement that in the end diverts us from the real issue?

So we share the goals that are really important to America's children. And I hope that you will work closely with us as we prepare materials for the committee, that then eventually we'll have concrete hearings on a concrete proposal. But the purpose of this Oversight hearing is to try to draw, as Oversight ought, from our experience, to try to chart a more enlightened path into the future. And I look forward to working with you as we try to chart that path.

And I appreciate the indulgence of the committee in allowing the Secretary to answer fully the members' questions. And I thank you very much.

Mr. MATSUI. Will the gentlelady yield?

Chairman JOHNSON. I will be happy to.

Mr. MATSUI. Are you saying that HHS has been in discussions with the Governors and with the appropriate Republican chairs on this issue?

Chairman JOHNSON. No, no, I am not saying that.

Mr. MATSUI. Well, how do we propose that they get input? Because you were suggesting that suggestions and input be part of this process. I am wondering how we are going to be able to provide that.

Chairman JOHNSON. I have raised the specific issue in my concluding comments about what is going to be the governance language of any children's services block grant, what would be the accountability mechanism; and I raised that through my questions, and I open that to the Secretary and the administration for their full input on those issues.

Mr. MATSUI. And I understand that, and that is great, and it is in the hearing record. But then how does that get into the discussions between Governor Engler, Governor Thompson and those who are negotiating on behalf of your side? Because that is where I think the issue is. And frankly, we don't know yet whether the Contract With America or the block grant proposal that we have been reading about in the newspaper or one of a number of others is going to be on the table.

And as I think Mr. McDermott mentioned, we are going to be marking this up, I would presume, in another 2 or 3 weeks, both in the subcommittee and the full committee. And I mean, I have to say that I appreciated Assistant Secretary Bane's testimony, but she really couldn't respond to a specific proposal. And then when we raised a specific proposal on that side of the aisle, we hear that it is irrelevant, that the chart is irrelevant because that is not what the Republican proposal is.

Chairman JOHNSON. She could respond with a specific proposal that is the subject of this hearing, and that is the 427 reviews. That is the subject of this hearing, and that is what people are here to respond to, and that is what I would expect to get them to respond to.

Mr. MATSUI. If that is what we were supposed to do, that is fine, but then you raised——

Chairman JOHNSON. That is the topic of the hearing.

Mr. MATSUI. You raised the issue of the block grants, though. So at least in your opening statement, we were told block grants were going to be an integral part of this discussion.

Chairman JOHNSON. There is already a proposal on the table out there, that has been introduced, that has a lot of block granting in it; and that is being heard, as we speak, by the Human Resources Subcommittee. We are looking at a special aspect of that. It is my hope that, through this hearing, we will have very concrete, clear input into the form that the chairman's mark will take.

Now, I have certainly spent many years trying to influence chairman's marks before they came out and trying to influence them after they came out. And you know as well as I know that no matter who is in charge, there are legislative initiatives submitted, there is a hearing process, and we all try to influence the chairman's mark.

Mr. MATSUI. I know. Let me say you will have much more influence than I will have.

Chairman JOHNSON. I hope that through good oversight work that we as the Oversight Subcommittee will be able to work with the administration in an honest enough and effective enough way that we will have some significant input into that. It will certainly enable us at full committee, and on both sides of the aisle, to do that work.

Mr. MATSUI. Madam Chairman, I think this hearing is great and I really commend you for holding it; and I think it is necessary. The only issue I raise is the fact that I hope that—and it is not your decision, I know, or partly your decision, but I hope that we get to see what the final proposal will be soon, so we can give the administration, us and everyone else, an opportunity to react. Because at this time we really don't know and we would like to find out.

Because we are talking about revolutionary changes.

Chairman JOHNSON. I hope that you will get to see them more in greater advance than we used to get to see the chairman's marks, either subcommittee or full committee. And we have shown in a number of ways, both by assuring minority input into the setting of this agenda, as has taken place on some other subcommittees, that we are going to try to proceed in a little different fashion than we have in the past.

But I certainly can make no guarantees about what will happen in the future, because we are in a terribly constrained timeframe, because we have combined not only some reform initiatives, but we have combined that reform initiative agenda with, now, also the balanced budget agenda, which creates a slightly different situation than we had anticipated when the Contract was written.

So here we are. It is work we must do. I hope we will do it together, both with your department and in a bipartisan way. There will be limits to that bipartisanness, and of course I understand and accept that, but we will keep you as well informed as we possibly can.

Thank you, Madam Secretary.

The next panel would come forward, please. And now, this panel, we will enforce the 5-minute rule on the speakers and also on the committee members, so that we will get through both panels in a fairly timely fashion.

I do very much appreciate your input. I know from the staff's reports that they have talked with you extensively, and we are going to hear some excellent input on both the benefits and possibilities of greater flexibility and also the difficulties and shoals in those waters.

We will start, please, with Patricia Balasco-Barr, director of the Division of Youth and Family Services, the Department of Human Services, from the State of New Jersey. Welcome, Ms. Balasco-Barr.

STATEMENT OF PATRICIA BALASCO-BARR, DIRECTOR, DIVISION OF YOUTH AND FAMILY SERVICES, NEW JERSEY DEPARTMENT OF HUMAN SERVICES

Ms. BALASCO-BARR. Good morning. I am Pat Balasco-Barr, director of the New Jersey Division of Youth and Family Services, an agency within the Department of Human Services in New Jersey.

I am here on behalf of Human Services Commissioner William Waldman, who is with Governor Christine Todd Whitman this morning, because today is our State budget message.

Chairman Johnson and members of the Committee on Ways and Means, Subcommittee on Oversight, I want to thank you for the opportunity to provide testimony today regarding the current structure of funding available through title IV–B and IV–E of the foster care and adoption assistance.

The Division of Youth and Family Services in New Jersey, commonly called DYFS, is the single organizational unit responsible for IV–B and IV–E; and we take very seriously the mandate of Public Law 96–272 to make reasonable efforts to prevent out-of-home placement. Our child protective and child welfare practices have emphasized meeting the needs of children and their families in their own homes, and when that is not possible, in the most homelike setting and in the place closest to the youngster's home community.

DYFS operates 40 field offices, which serve a caseload of almost 50,000 children and their families on any given day. New Jersey is very proud of the fact that the overwhelming majority of these children, more than 83 percent, reside in their own homes. Only 7,900 children are served in out-of-home settings. The majority of these children, some 5,900, are in foster family care. The remaining children are in group home facilities, residential facilities, or small, community-based group homes. Sixty percent of the children in terms of eligibility for Federal funding—approximately 60 percent of the total child placement population in our State are eligible under IV–E.

New Jersey's use of out-of-home placement has not only remained stable over the past decade, it actually declined some 8 percent between 1989 and 1994. Over the same period of time, the reliance on out-of-home placement has risen dramatically in most other States.

New Jersey participated in the pilot program of the existing section 427 monitoring system in 1981, the initial section 427 compliance review in 1982, and three subsequent triennial reviews. I am pleased to say we passed each of those program reviews. Nevertheless, our experience has been that the task of documenting continuing compliance with the section 427 protections, much more than simply conducting our practice in the way that satisfies these norms, has been cumbersome and time-consuming for casework staff.

Specifically, we believe that the Federal approach to measuring compliance with the principles of Public Law 96–272, has inadvertently evolved to the point that it emphasizes the letter rather than the spirit of the law. In general, section 427 reviews have been more concerned with the tracking of precisely worded statements or process, rather than evidence of the actions themselves. Although New Jersey has passed these compliance reviews, we have come to conclude that this orientation has distorted the original intent of the law.

New Jersey has a case review system specifically designed to meet the requirements of section 427. In fact, New Jersey enacted a child placement review act in 1978, 2 years before section 427 requirements were imposed. The State law essentially requires parents, caseworkers, children, foster parents, guardians ad libitum to participate in the review process. The 427 review is duplicated by the child placement review committee, which works out of the judiciary part of government in New Jersey. We also then have the judicial review, when a child is under the supervision of the court.

So, in essence, there are three kinds of reviews that are monitoring New Jersey's compliance with Public Law 96–272: Compliance with the requirements of IV–E and IV–B eligibility, and the movement of children toward permanency.

One of the things that came to our attention in preparing for this hearing was so many of our children in New Jersey return home prior to the requirement of a section 427 review. And we take great pride in the fact that that family preservation initiative is working much, much better than our 427 review would ever tell anybody.

The budget resources required for 427 review is about $2.5 million. The workload management studies that a minimum of 14 percent of a caseworker's direct service time is expended for children in out-of-home placement is spent in documentation of 427 requirements. In addition, compliance with these standards involves the time of supervisory, management and support staff to fully integrate these section 427 driven actions.

DYFS has a corps of 14 regionally based third-party section 427 reviewers who convene and conduct the placement reviews. We have no doubt that reviews have benefited children in out-of-home placement, but we think that the system—does that mean I stop?

Chairman JOHNSON. Well, you are close to the end because you are summarizing now.

Ms. BALASCO-BARR. The purpose of the law is being met in New Jersey, and the purpose of the law toward good child welfare practice is being met. But when you look at the quality and the numbers of reviews that we are doing in New Jersey, you begin to wonder, how many times does it take you to figure out whether you are on a good case practice basis with each child? Would there be deficiency—would there be efficiencies if we block granted child welfare programs; and would foster children be better served if we plowed overhead into additional resources?

I think there is a misconception when we talk about administrative costs, that you think of whole lots of folks that look like me sitting around and that is how the salary is paid. But administrative costs has to do with cars, has to do with desks and computers and training for staff. It has to do with the other things that support a caseworker's ability to do the work, what we call "good child welfare practice."

I appreciate the opportunity to present the testimony to you today and I am available for questions after the rest of our panelists talk.

Chairman JOHNSON. Thank you very much, Ms. Barr.

[The prepared statement follows:]

TESTIMONY OF
DIRECTOR PATRICIA BALASCO-BARR
DIVISION OF YOUTH AND FAMILY SERVICES
NEW JERSEY DEPARTMENT OF HUMAN SERVICES
BEFORE THE COMMITTEE ON WAYS AND MEANS
SUBCOMMITTEE ON OVERSIGHT

JANUARY 23, 1995

Good morning. I am Pat Balasco-Barr, Director of the New Jersey Division of Youth and Family Services, the child protective and child welfare service agency within the Department of Human Services. I am here today on behalf Human Services Commissioner William Waldman who was not able to appear before the Subcommittee today. Commissioner Waldman is joining New Jersey Governor Christine Todd Whitman as she presents her State Budget Message for fiscal year 1996.

Chairman Johnson and members of the Committee on Ways and Means Subcommittee on Oversight, I want to thank you for the opportunity to provide testimony today regarding the current structure of funding available through the Title IV-B of the Social Security Act for Child Welfare Services and Title IV-E of the Act for Foster Care and Adoption Assistance.

The Division of Youth and Family Services, known in our State as DYFS, is the State's Title IV-B and Title IV-E single organizational unit. We, in New Jersey, take seriously the mandate of P.L. 96-272 to make reasonable efforts to prevent out-of-home placement. Our child protective and child welfare practices have emphasized meeting the needs of children and their families in their own homes, or when that is not possible, in the most home-like setting appropriate to the child's needs in or near the youngster's home community.

A brief overview of the Division's operations and caseload statistics illustrates that this is not simply a statement of philosophy -- rather, it is a matter of practice. DYFS operates 40 field offices which serve a caseload of almost 50,000 children and their families on any given day. New Jersey is very proud of the fact that the overwhelming majority of these children -- more than 83 percent -- reside in their own homes. On any given day, only 7,900 children are served in out-of-home settings. The majority of these children, some 5,900, are in foster family care. The remaining 2,000 children are receiving treatment services in group care facilities, and to the maximum extent possible, small scale, community based group homes are used in lieu of large scale residential facilities. In terms of eligibility for federal funding, approximately 60 percent of the total child placement population in our State are eligible under Title IV-E.

New Jersey's use of out-of-home placement has not only remained stable over the past decade, it actually declined some 8 percent between 1989 and 1994. Over this same period of time, the reliance on out-of-home placement has risen dramatically in most other states.

New Jersey participated in the pilot-test of the existing Section 427 program monitoring system in 1981, the initial Section 427 compliance review in 1982 and three subsequent triennial reviews. I am pleased to say that we passed each one of these program reviews. Nevertheless, our experience has been that the task of documenting continuing compliance

with the Section 427 protections -- much more than simply conducting our practice in a way that satisfies these norms -- has been cumbersome and time-consuming for case work staff. Specifically, we believe that the federal approach to measuring compliance with the principles of P.L. 96-272 has inadvertently evolved to the point that it emphasizes the letter rather than the spirit of the law. In general, Section 427 reviews have been more concerned with the tracking of precisely worded statements or process, rather than evidence of the actions themselves. Although New Jersey has passed these compliance reviews, we have come to conclude that this orientation has distorted the original intent of the law.

I would like now to address the specific questions that I believe are of concern to the Sub-Committee.

HOW DOES NEW JERSEY MEET THE SECTION 427 PROTECTIONS?

New Jersey has a case review system specifically designed to meet the requirements of Section 427. In fact, New Jersey enacted the Child Placement Review Act in 1978, two years before the Section 427 requirements were imposed. State law requires the early and periodic review of children placed into out-of-home settings by the Division of Youth and Family Services The system established by the law is a combination of citizen review boards and a judicial review of the circumstances of a child's placement, including: reasons for placement, current conditions of the placement, the appropriateness and progress of the plan for the child. Parents are invited to participate. Since the 12 month periodicity of the State Child Placement Review system was less frequent than the six month frequency subsequently required by federal law, the Division provided for alternating interim 6 month reviews by conducting independent, third-party placement conferences -- known as "administrative reviews" under Section 427. These conferences meet the standards of the reviews required by Section 427 in that they are conducted by staff not involved in the decision-making or service delivery for the case, parents are invited to attend, formats for documenting and guiding the review are completed by those Division staff attending which record all the assurances required.

The driving purpose of the federal law mandating a review system was noble. The reviews were intended to assure -- through an independent process of monitoring and problem-solving -- that in each case reasonable efforts have been made to prevent placement, that the placement is appropriate, and that reasonable efforts are being made to ensure progress in reuniting the child with his family or in moving towards an alternative permanent living arrangement. What we have found, however, is that an inordinate amount of effort is needed not to ensure compliance with the Section 427 protections but, rather, to ensure that documentation of each of the Section 427 protections is available in a formula statement that precisely mirrors the provision to which it applies. For example, we have found over the course of these triennial reviews that the requirement that efforts be made to place children in close proximity to their homes had to be demonstrated through a discussion of alternative placement sites -- rather than simple evidence that the foster home selected was within the same community. In other words, actual proximity appeared to matter less than a statement in a particular form discussing the efforts to identify other possible placements that did not meet the proximity protection. In some cases, these statements were required even though it was manifestly clear that the State had met the proximity requirement.

WHAT KIND OF BUDGET RESOURCES HAVE BEEN ABSORBED TO COMPLY WITH THE SECTION 427 PROTECTIONS

To meet the principles embodied in the law, New Jersey has made a considerable investment of resources from not only the Division of Youth and Family Services, but also from the judiciary. First, the Division's front-line field staff must conduct their practice in a way that satisfies the federal requirement to make reasonable efforts to prevent placement and that ensures case plans for children and families address the relevant Section 427 protections. In addition, field staff must participate in the third party review of placement every six months, alternating as an in-house placement conference or a review before a citizen-based Child Placement Review Board. We estimate from workload management studies that a minimum of 14 percent of a case worker's direct service time expended for children in out-of-home cases is spent in the documentation of the Section 427 requirements, including writing the case plan and participating in the formal third-party reviews. In addition, compliance with these standards involves the time of supervisory, management and support staff to fully integrate these Section 427-driven actions into the agency's practice and record-keeping.

DYFS also maintains a corps of 14 regionally-based third-party "Section 427" reviewers who convene and conduct placement conferences that are attended by the parents, the supervising case worker, his or her supervisor, the foster parents, and the child, if appropriate. The salary and support costs for these 14 reviewers is approximately $1 million.

In addition, the State's network of Child Placement Review Boards, which serve as arms of the Family Division of the New Jersey Superior Court, operate in all 21 counties. Although staffed by volunteers, the cost to the State Judiciary to support local board operations -- as well as the cost of bench time needed to review and make a judicial determination of each board recommendation -- is considerable.

Clearly, these expenditures exceed the approximately $2.7 million in Title IV-B incentive payments that New Jersey receives in return for complying with the Section 427 requirements. But, the question of whether these efforts are worthwhile is more complex than whether they are simply cost neutral. We believe that the basic intent of the Section 427 protections is sound. New Jersey would pursue them even if they were not mandated by federal law. However, we also believe that the monitoring of Section 427 compliance has progressed well beyond encouraging affirmative outcomes for children in placement. Rather, it has become an end in itself -- instead of focusing on the positive outcomes that we, as child welfare practitioners, owe to the children in our care.

HAVE THE REVIEWS BENEFITTED CHILDREN IN FOSTER CARE?

We have no doubt that reviews have benefited children in out-of-home placement, but we also think that the system as it has developed fails to implement the intent of the law. The prevention of placement -- to allow children to continue living in their own homes -- is the purpose of the law. However, the focus of Section 427 compliance reviews has become the microscopic inspection of statements about the procedures that occurred after a child entered placement -- rather than a common sense examination of the outcomes actually achieved. Although a review of the

circumstances of a child's placement is essential if we are to ensure movement toward permanency, the focus of these reviews should be redirected toward pre-placement events (i.e., prevention of placement) as well as concrete indicators of case progress or movement.

To illustrate this view, we only need to point out that gains on behalf of children in placement -- whether measured by the rate of placement utilization, time in placement, or qualitative measures of placement appropriateness -- have continued in New Jersey well past the point that one would expect through Section 427 protections alone. We believe that our investments in family preservation and family supportive services have yielded substantial additional benefits, far beyond those of the Section 427 protections alone, for the children in our care. Ironically, under the existing 427 monitoring mechanism, a state such as New Jersey that is highly successful at preventing placements and moving children home faster -- concrete outcomes for children -- could nevertheless fail a Section 427 program audit on procedural grounds. In fact, the case sampling methodology employed by the Administration for Children and Families in conducting compliance audits systematically exclude any placement that is of six months duration or less -- ignoring significant numbers of children who have been quickly and successfully reunited with their families.

WOULD THERE BE EFFICIENCIES IF WE BLOCK GRANTED CHILD WELFARE PROGRAMS AND WOULD FOSTER CHILDREN BE BETTER SERVED IF WE PLOWED OVERHEAD INTO ADDITIONAL RESOURCES?

New Jersey initially developed and has since enhanced, an extensive/complex procedural infrastructure to comply with the essential protections currently required under Section 427. The principles of comprehensive case planning, aggressive service delivery, periodic independent reviews and judicial determinations of the continuing need for placement are fundamental elements of good casework practice. Therefore, if child welfare programs were block granted, we would most likely choose to maintain all or most of the current requirements. Maintaining even the basics of the current system would not allow for much direct casework overhead to be freed to reinvest into additional resources.

There could be significant savings, however, to the extent that states were no longer required to conduct continuing periodic reviews of certain categories of cases -- such as permanent placements with relatives or long-term foster care -- that had, in effect, achieved permanent outcomes. Nevertheless, states should have the opportunity to include the principles of the law into their practice and monitor their implementation in a more flexible way. The states should also be encouraged to pursue the state of the art improvements in child welfare service philosophy and practice as they evolve and not be tied to the limits of what was once the best thinking to meet the needs of the time.

Towards that end, we would welcome the flexibility to reinvent the Section 427-type protections that would come with a block granting of Title IV-B. We believe, however, that the potential for achieving economies under a block grant while maintaining the current level of child welfare services would be minimal at best.

With respect to the block granting of Title IV-E, we believe that a fundamental issue has to deal with the widely divergent levels of claims being made by the various states at the present time. Any block grant conversion that limited each state to its current level of Title IV-E claiming would be unfair. As an alternative, we would suggest that a funding formula be used which would base each state's share of national funding appropriation on some statistical measure or demographic proxy of each state's actual need. Of course, this approach would also need to reflect an adequate total appropriation for this purpose. Finally, in keeping with my next point, we also believe that some additional incentive payments should be considered for states that exceed certain normative levels of outcome for children at risk of or in foster care.

WHAT MINIMAL FEDERAL REQUIREMENTS WOULD NEED TO BE RETAINED?

It is appropriate for the federal government to provide the states with guidance, in the form of general requirements, for the expenditure of the child welfare dollars that it provides. More specifically, we do not take issue with the basic requirements of Section 427 for placement prevention, for the selection of the placement that is most appropriate to the child's needs (including close proximity to the child's family and community, when proximity is relevant), for prompt initial review and subsequent periodic reviews of the placement, for judicial oversight, and for efforts to achieve permanency. We have no quarrel with the intent of Section 427 at all. We would, however, like to see the federal government adopt a far more flexible and common sense approach to the determination of compliance, and most importantly, one that emphasizes actual circumstances, events, and outcomes rather than process statements and descriptions.

In a practical way, this would amount to requiring a state to show evidence that the basic Section 427 protections are in place -- through the current "administrative review" that each state must first pass before it proceeds to a case record based field review of compliance. Overall compliance should then be based upon the state's documentation of positive outcomes in terms of placement prevention, length of stay in placement and other measures of movement towards permanency. We believe, after 14 years of experience with the provisions of P.L. 96-272, that simply having the Section 427 procedural safeguards in place in no longer enough. States should be held accountable for success in preventing placements, reunifying families and moving children quickly towards permanency. With the impending requirements of the nationwide Adoption and Foster Care and Analysis Reporting System (AFCARS), the states will be in a position to report outcome/case flow data that can be used towards this end.

In closing, Madam Chairwoman, I would like to thank the Sub-Committee for allowing me the opportunity to discuss New Jersey's experience with the current Section 427 requirements as well as our view of the potential impact of block granting the Title IV-B and Title IV-E programs. We, at the New Jersey Division of Youth and Family Services, join with you in seeking to strengthen our ability to prevent placement, preserve families and to quickly achieve permanent outcomes for children in foster care. Thank you.

Chairman JOHNSON. Mr. Horn, it is a pleasure to welcome you back to the committee.

STATEMENT OF WADE F. HORN, PH.D., DIRECTOR, NATIONAL FATHERHOOD INITIATIVE, AND FORMER COMMISSIONER, ADMINISTRATION FOR CHILDREN, YOUTH AND FAMILIES, U.S. DEPARTMENT OF HEALTH AND HUMAN SERVICES

Mr. HORN. Thank you. It is a pleasure to be back after a 2-year hiatus from appearing before this committee.

My name is Wade Horn, and I am the director of the National Fatherhood Initiative, an organization whose mission is to restore responsible fatherhood in America. I also am the former U.S. Commissioner for the Administration for Children, Youth and Families in the Department of Health and Human Services, and served as a presidential appointee on the National Commission for Children. I have submitted a more lengthy statement for the record, and I would just like to summarize my major points.

Child welfare today is not just in crisis, it is at a crossroad. We have to determine whether we want to continue on down the road we are on, toward more micromanagement and regulation of the child welfare system, or whether we want to change directions and provide States and local agencies with greater flexibility to do the job that they want to do. I am here to testify that I think we need to change direction.

There are two major problems with the child welfare system today. The first is that there are far too many funding streams, and they are far too categorical in nature. By my count, there are at least 17 different funding authorities within the Children's Bureau. There are an additional four within the National Center for Child Abuse and Neglect. There are several others scattered throughout the Administration for Children and Families. There are three in the Department of Justice. And I have just learned yesterday that there is one under the jurisdiction of the Banking Committee, a $76 million family unification program that quite frankly I didn't know existed.

Why is it that States should have to negotiate this labyrinth of Federal programs in order to set up one single, comprehensive, seamless system of services to take care of the needs of children? The current system is, quite frankly, lunacy. It doesn't make a lot of sense.

The second problem is that I don't think we can find anybody that says that section 427 reviews are doing what they were expected to do or intended to do. Despite wonderful intentions, what we have is a system where you can pass a section 427 review, and yet be brought to court and found wanting in terms of protecting the welfare of children. I think there are two reasons for this.

First of all, the protections as mandated within the law, are in some cases far too ambiguous and difficult to define so States have to kind of guess at what it is the Feds mean and how it is they are to document that, in fact, a particular protection was met.

Second, as a former homemaker myself in the Department of Child and Family Services in the State of Illinois, way back in 1977, I know that it is far easier to have an understanding about whether a particular case is in fact going well if you are part of

that community. It is simply too difficult for a Federal bureaucrat, either here in Washington or in a regional office, to travel 200 or 300 miles, sometimes many thousands of miles, to get an understanding about what is going on with a particular child by reading the case record.

How can you tell whether a particular service was appropriate if you don't know the full range of services that are available in that community? It just doesn't make sense to ask the Federal Government, with its limited administrative resources, to take on that kind of responsibility and oversight.

I have two major recommendations for the subcommittee.

The first is to reduce the categorical nature and number of funding streams in child welfare. I recommend that you collapse all of the spending within the Children's Bureau that is dedicated toward child welfare, except for foster care maintenance payments and adoption assistance maintenance payments, along with the four programs in the National Center for Child Abuse and Neglect, those child welfare programs within the Justice Department and the one child welfare program under the jurisdiction of the Banking Committee, into one large block grant to allow States to implement a comprehensive, seamless system of services to protect children.

My second recommendation is that we devolve responsibility for oversight at the case level to the States. It seems to me there are some possibilities already being explored by the States to do precisely this. One particularly promising approach is the use of so-called citizen review boards.

There is a recent study of the use of citizen review boards in Douglas County, Kans., that found that their use resulted in significant reductions in judicial and administrative delays, speedier implementation of permanency plans, and most importantly, a significant reduction in time spent in out-of-home placement.

An oversight system that is much more tied to the local community will have a better understanding of the resources and needs of that community, and can therefore respond in a much more aggressive fashion to ensure that children are protected, than you can if you come from Washington, D.C., for a 1- or 2-week visit.

I am not suggesting that the Federal Government has no role to play in child welfare. In fact, I do believe that the child welfare amendments of 1980 were instrumental in helping to improve the child welfare system. The problem is that since that time we have gone down the road toward a much more fragmented and much more overregulated system. What we need to do is reverse course and get out of the business of micromanaging States—micromanaging not only their practice but their budgets—and the best way to do that is through a block grant approach.

[The prepared statement follows:]

Statement by Wade F. Horn, Ph.D.
January 23, 1995

My name is Wade F. Horn, Ph.D. I am the Director of the National Fatherhood Initiative, an organization whose mission is to restore responsible fatherhood as a national priority. Formerly, I served as Commissioner for Children, Youth and Families within the U.S. Department of Health and Human Services, and was a presidential appointee to the National Commission on Children.

The child welfare system is in crisis. Data reported through the Voluntary Cooperative Information System (VCIS) indicate that more than 445,000 children age 0-18 were in foster care at the end of FY 1993, a 65% increase since 1983. The cost of foster care and adoption assistance under Title IV-E of the Social Security Act now exceeds $3 billion, ***nearly ten times*** the amount expended in FY 1981. We are spending more and more money on child welfare, and getting less and less in return. Indeed, despite ever increasing money spent on child welfare, statistics from the National Center for Child Abuse and Neglect indicate that in 1991 there were a total of 992,600 substantiated cases of abuse or neglect, an all time high.

Today is not the first time that a crisis in the child welfare system has made reform necessary. In the 1970's, the system was overburdened with an estimated 500,000 children in foster care. At that time, few states had adequate systems in place for ensuring quick resolution of foster care episodes, through either reunification or placement for adoption. Some states and local agencies could not even readily determine the location of a child once that child was placed in foster care. The result was hundreds of thousands of children in "foster care drift," bouncing from one foster care home to another with no agreed upon long term plan or strategy for resolving the concerns facing children in out-of-home care.

This dire situation changed dramatically with the implementation of the Child Welfare Amendments of 1980 (PL 96-272). This law required states to implement a number of reforms, including a requirement to conduct an inventory of all children in foster care, the implementation of a statewide tracking and information system, and the development of a case review system with an emphasis on permanency placement. The Adoption Assistance and Child Welfare Act of 1980 also created title IV-E, thereby linking child welfare services available through title IV-B with the AFDC foster care program.

States were required by PL 96-272 to self-certify that certain administrative reforms had taken place, and then submit to periodic reviews by the federal government to ensure that these reforms, as well as additional protections specified in the law, were in place for children in out-of-home care. The incentive for states to comply with the law was the inclusion of additional Title IV-B payments if these reforms were implemented and operating to the satisfaction of the Secretary of the U.S. Department of Health and Human Services. The provision in PL 96-272 for on-going system oversight came to be known as Section 427 reviews.

The short-term results of the reforms embodied in PL 96-272 were impressive. The length of time children spent in foster care was sharply reduced and the total number of children in out-of-home care plummeted from over 500,000 in 1977 to approximately 270,000 in 1983. Since that time, however, the number of children in foster care has been increasing, and spending on child welfare has exploded. What happened?

During the 1980's, two crises greatly challenged the capacity of the child welfare system to protect children. First, beginning in the mid-1980's, the crack cocaine epidemic dramatically changed the type of client being served by the child welfare system. Whereas the typical foster care placement in the 1970's and early 1980's involved neglect or highly episodic, and stress related, abuse, the new crack cocaine cases frequently involved much more severe and chronic abuse resulting in longer and repeat stays in foster care. Second, the 1980's saw an acceleration of the trend toward fatherless households. Given evidence that abuse is up to

forty times more likely to occur when the biological father is not living in the home[1], the trend toward increasing father absence greatly increased the number of children interacting with the child welfare system.

The federal government should have been in the forefront encouraging states to respond innovatively to these new challenges. Instead, the rigidity of PL 96-272 necessitated that states spend valuable resources and time trying to negotiate cumbersome rules and regulations in order to maximize federal reimbursement under the Title IV-E administrative costs program, and to submit to burdensome paper reviews required under Section 427. In addition, federal attempts to reform the system have mostly gone in the wrong direction. Instead of increasing flexibility and encouraging experimentation, recent reforms have actually ***increased*** the rigidity and categorical nature of federal funding streams.

A case in point is the relatively recent passage of legislation to provide funds for family preservation services. Although some advocates of family preservation services claim that out-of-home placement is prevented for as many as 90% of children served, the few experimental evaluations of family preservation services to date have not shown substantially lower rates of placement in foster care 4-6 months after the termination of family preservation services. In addition, according to Toshio Tatara of the American Public Welfare Association, the dramatic increase in children in foster care placements is not due to an increase in the rate at which children are entering foster care, but rather to a significant decline in the rate at which children are ***exiting*** foster care[2]. Despite the absence of empirical evidence attesting to its effectiveness, advocates for family preservation services were successful in persuading Congress to legislate a new funding stream which can be utilized ***only*** for family preservation and support services. Consequently, whether or not such services are effective or best meet the needs of a particular community, states are now required to use a substantial portion of federal funds to provide family preservation services.

In addition to the inflexibility and categorical nature of federal funding streams, the legislatively imposed requirements of Section 427 may have also been a hinderance to reform for at least two reasons.

First, the protections mandated in PL 96-272 are highly subjective and difficult to operationalize. For example, one of the case plan requirements is that a child be placed "in close proximity to the parents' home." What does close proximity mean? Does it mean the same thing in New York City as in Utah? What if it was not appropriate, in a particular case, to place a child in close proximity to his or her parents. What should one do then? Lacking clear definitions and unambiguous requirements, states are often forced to "guess" at the documentation required to pass a Section 427 reviews.

Second, many of the protections under Section 427 are highly dependent upon an intimate understanding of the individual case. How would a bureaucrat from Washington, D.C., truly be able to have an opinion as to the "appropriateness of services being provided" to a particular family in rural Kansas or urban Hartford? A much more rational and defensible system of oversight would be locally-based, for a local reviewer is in a far better position to understand local conditions and circumstances than a one or two week visitor from Washington, D.C., or from a regional office often hundreds of miles away. Lacking this intimate knowledge of local conditions and circumstances, the Section 427 reviews have become paper exercises, unable to address the complexities and nuances of the individual case.

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[1]Daly, M. and Wilson, M. (1985). Child Abuse and Other Risks of Not Living With Both Parents, *Ethology and Sociobiology*, 6, 197-209.

[2]Tatara, T. U.S. Child Care Flow Data For FY 92 and Current Trends in the State Child Substitute Care Populations, *VCIS Research Notes*, no. 9, August 1993.

What is needed to improve the child welfare system is greater state flexibility, not more specialized funding streams. The current system is simply too categorical, burdensome, and prescriptive on State agencies, resulting in much time and resources being diverted to satisfying federal paper requirements and away from serving the needs of children.

Specifically, I recommend that all child welfare discretionary and state formula grant programs, including those currently housed within the National Center for Child Abuse and Neglect, be combined with monies available under the Title IV-E Administrative Costs program, into one large state formula block grant program. States and localities could then use these funds to build a truly seamless system of comprehensive supports for families without having to satisfy the idiosyncratic and sometimes conflicting requirements of dozens of federal programs. The role of the Federal government would be to foster experimentation in the delivery of innovative services, collect national data, and provide technical assistance in evaluating the impact of innovative services.

I further recommend that oversight of the child welfare system -- excluding fiscal accounting and oversight of Title IV-E maintenance payments -- be devolved to the States. This would mean a transfer of responsibility from the federal government to the States, with appropriate assurances that such oversight is independent of the child welfare agency administering the program, for ensuring a well-functioning, comprehensive child welfare system.

One possibility for ensuring effective state and local oversight of the child welfare system is to make greater use of citizen foster care review boards. According to the National Association of Foster Care Reviewers, citizen review boards are generally created by state statute, staffed by volunteers, and required to make case plan recommendations and maintain ongoing oversight of case planning for children and families in the public child protection system. Because the reviewer is a volunteer with no vested interest in the child welfare system, he or she can instead concentrate on the welfare of children. A recent study in Douglas County, Kansas, demonstrated that the use of citizen foster care reviewers resulted in significant reductions in judicial and administrative delays, speedier implementation of permanency plans, and, most dramatically, a significant reduction in time spent in out-of-home placement[3].

I am not suggesting that the federal government has no role to play in child welfare. Indeed, it was largely due to federal efforts that major positive reforms were instituted in the early 1980's. However, emboldened by initial success, the federal government apparently came to believe that it was the site of ***all*** wisdom, and over the past decade has imposed ever increasing and unnecessary burdens on state agencies.

It is time for the federal government to get out of the business of micromanaging state child welfare budgets and services. The most effective way of accomplishing this is through the use of state block grants. Then let us see whether children are better off living with the decisions of local communities, or with those made by federal bureaucrats here in Washington, D.C.

Thank you.

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[3]Study by Mary Ann Jennings, MSW, and Thomas P. McDonald, Ph.D., of the University of Kansas School of Social Welfare, as cited in *The Review*, volume 8, no. 2, summer 1994.

Chairman JOHNSON. Thank you very much, Mr. Horn.
Mr. Digre. Sorry, Digre.

STATEMENT OF PETER DIGRE, DIRECTOR, LOS ANGELES COUNTY DEPARTMENT OF CHILDREN AND FAMILY SERVICES, LOS ANGELES, CALIF.

Mr. DIGRE. Chairperson Johnson, members of the committee, thank you very much for the opportunity to be here today. My name is Peter Digre, and I am the director of the Los Angeles County Department of Children and Family Services, an agency which during 1994 responded to more than 165,000 reports of abuse and neglect. Today and every day, I am personally responsible for the care and nurturance and protection of 58,000 children.

Virtually every day, in the media, we hear about children who have been horribly abused. Usually this abuse is at the hands of parents, sometimes it is at the hands of temporary caretakers. Tragically, as we talked about earlier, there are times at which the child welfare system itself fails to live up to the minimum standards required to ensure the safety of children.

All of us agonize for these children, and overwhelmingly, the American people cry out that the safety and nurturance of these children must be the first priority for all of us.

I am deeply concerned that the combined potential of block grants for both welfare reform and for child welfare will have a severely negative impact on children in the child welfare system, for example, if procedures are implemented either federally or at the State level that remove large numbers of families from assistance in the juvenile court statutes throughout the country.

The definition of neglect includes food, clothing, shelter and medical care. Therefore, many of the children removed from assistance would flood into the child welfare system due to the inability of their parents to provide for the basic essentials of life. Our experience with the recession and the California 1992 AFDC cuts indicates that the numbers would be at least in the thousands and conceivably in the tens of thousands in Los Angeles County alone. In short, I truly believe that the Nation's foster care system may well grow geometrically.

This chart that I have attached for you documents the very intimate relationship between the economic well-being of families and children entering the child welfare system. Proposals—and I was very relieved to hear the Chairperson's comment—which would block grant child welfare entitlement programs would put the child welfare situation in the state of being confronted with an open-ended juvenile court mandate which could place countless numbers of new children into foster care. And if there is only a capped block grant to pay for their care, without hyperbole, we can conclude there would of necessity be a drastic decline in the quality of the care and the safety of the children in that system, as capped resources provide less and less adequate care for growing numbers of children.

Second, the issue of the safety of children also demands national standards for child safety. Public Law 96–272 embodied many years of collected wisdom regarding minimal standards. The 427 protections, to my mind, speak to very simple and very basic

things: Having case plans and goals, having cases reviewed by judges and case review boards periodically, and basic protections of parents' rights, like having your child placed close to home so you can be reunified with them.

Most importantly, what these standards have done is created a common vision and a common language which consistently focuses attention on the important outcomes for children, such as safety and all children's needs for permanent homes. As such, I truly believe that the essence of these goals, that the spirit of these goals, has extraordinary value.

I would like to ask the committee to enhance the 427 protections by including requirements that are universally vital to maximize the safety of children. Just a few examples: Children are injured in care and with their own parents if they are not visited; clearly, minimal standards of visitation should be included. Children can be left with child molesters if there are no criminal checks or child abuse background checks. Youth being removed from foster care need training to enter adulthood, or else they become homeless and they enter deprived.

I would like to suggest a number of ways in which flexibility could also be achieved. No. 1, there are numerous small categorical programs which could simply be rolled up and included in IV–B.

No. 2, 10 waivers is hardly enough authority to administer IV–B and IV–E. I think HHS should have the capacity to give at least 50, at least 1 for each State.

No. 3, the concept of tax credits for adoption is very powerful and very important and we support it wholeheartedly.

No. 4, the current rulemaking to consolidate State planning requirements for children's programs should be expanded to include other arenas, such as substance abuse prevention and treatment and housing that families in the child welfare system badly need.

In closing, please analyze all proposals for welfare block grants from the perspective of the safety of children. Second, please enhance the national standards for child safety. Please do not eliminate them. The decisions that we make will affect the safety of millions of children.

Thank you very, very much for the opportunity to be part of the discussion.

[The prepared statement and attachment follow:]

TESTIMONY OF PETER DIGRE, DIRECTOR
LOS ANGELES COUNTY DEPARTMENT OF CHILDREN & FAMILY SERVICES

Congresswoman Johnson, Members of the Committee. Thank you for the opportunity to testify today. My name is Peter Digre and I am the Director of the Los Angeles County Department of Children and Family Services, a public child welfare agency which, during 1994, responded to more than 165,000 reports of child abuse and neglect. Today, and every day I am personally responsible for the protection, care and nurturance of 58,000 children.

CONTEXT

We are confronted today with a myriad of proposals to restructure the program and financing for the nation's welfare and child welfare system - some of the proposals are quite radical. Neither I nor Los Angeles County have completed our analysis of the many variations on the evolving proposals so I would like to focus my comments on some of the crucial questions and issues which I hope Congress reflects on in reaching its decisions.

OUR FIRST PRIORITY MUST BE CHILDREN AND THEIR SAFETY

Virtually every week, if not every day, on our television networks, radio programs and newspapers and magazines, we see, hear and read about children who have been abused and neglected -- children who suffer at the hands of those whom our society has trusted to nurture and raise. Often, these people are the parents who have brought the children into the world; sometimes they are temporary caretakers whom agencies like mine have trusted to provide care for children who have already suffered abuse at the hands of others. Tragically, there are times in which the child welfare system itself fails to live up to the minimal standards required to insure the safety of children.

We, the people, the entire American public, agonize for each and every one of these children and their families. Overwhelmingly and universally, the American people cry out - THE SAFETY AND NURTURANCE OF CHILDREN MUST BE THE FIRST PRIORITY FOR ALL ELECTED AND APPOINTED OFFICIALS. The media knows the depth of this cry and holds us all strictly accountable.

POSSIBLE IMPACT OF SOME REFORM PROPOSALS ON CHILD SAFETY AND NURTURANCE

From the perspective of child safety and nurturance, many questions need clarification regarding proposals to block grant programs such as welfare, food stamps, child welfare and foster care.

I am extremely concerned that data exists which indicates that the combined impact of a block grant for welfare reform and a block grant for child welfare/foster care could have a severely negative affect on the safety of children and the child welfare system.

Block granting itself eliminates the traditional individual entitlement for AFDC and food stamps. During times of recession, capped state block grant resources will be confronted with growing numbers of families with children needing assistance. This will logically lead to significant reductions in the assistance provided to each individual family. In addition, proposals to drop families and children from assistance due to time limits or other reasons may involve eliminating as many as 5 million children nationally from assistance, including several hundred thousand children in Los Angeles County alone.

Since, in Juvenile Court statutes throughout the Country, the definition of "neglect" includes lack of food, clothing, shelter and medical care, many of the children removed from assistance would flood into the child welfare system due to the inability of their parents to provide for the basic essentials of life.

Our experience with the recession and the California 1992 AFDC cuts indicates that the numbers would be at least in the thousands and conceivably in the tens of thousands in Los Angeles County alone. In short, the nation's foster care system may well grow geometrically.

The attached chart indicates the intimate relationship between the economic well being and economic opportunities of families and the reporting of child abuse and neglect. You can also surmise the extreme magnitude of this issue by realizing that 1.8 million adults and children in Los Angeles County today are sustained at least in part by the welfare and food stamps system - this is more than 20% of the total County population.

Given this intimate relationship between economic sustenance and the entry of children into the child welfare and foster care system, it is not speculative to predict that a significant proportion of children for whom assistance is terminated or curtailed will enter the child welfare/foster care system.

Proposals have also been advanced to eliminate the child welfare/foster care entitlement and block grant child welfare related programs including family preservation, foster care, child welfare supervision and support for emancipating foster children to achieve independence. In short, resources would be capped and not need or workload driven.

Obviously, if both the welfare reform block grant and the child welfare block grant are implemented, the child welfare system could be confronted with an open ended Juvenile Court mandate and entitlement that would place countless numbers of new children into the foster care system, while only having a capped block grant to pay for their care.

Without hyperbole, we can reasonably conclude that there would be a drastic decline in the quality of care and safety for children in the child welfare and foster care system as the "capped" resources provide for growing numbers of children. There will be more children per caretaker, less support per caretaker, less training for caretakers, less social work supervision and treatment by less trained children's social workers, less preparation for independence, less adoptions, less family preservation efforts...The consequences may well be tragic.

THE SAFETY OF CHILDREN DEMANDS BASIC NATIONAL STANDARDS

Public Law 96-272, the Child Welfare and Adoption Assistance Act of 1980, was the result of many years of work by child welfare professionals, children's advocates and members of Congress. This measure has enjoyed strong bipartisan support.

PL 96-272 was intended to remedy a number of child welfare systemic problems using a "carrot and stick" approach.

The carrot is the Title IV-B incentive funds each State receives, and the stick is the provision that the State's caseload is in compliance with each of the Section 427 child protections.

The issues before your Committee today are whether these "427 reviews" have served to improve the lives of children; and whether eliminating these requirements and block granting these funds will strengthen the states' abilities to deliver child welfare and foster care services to children.

The 427 protections actually speak to only four dimensions in the foster care arena: case plans, periodic foster care status review; administrative review; and procedural safeguards relative to parents' rights. Each of these dimensions speak to both process and outcome for the children and families in whose lives the state finds it necessary to intervene.

I believe that these protections represent sound practice standards, a common sense approach to assuring that each child and family will be well-served. They represent a logical process for assuring that child welfare services are provided in a deliberate, thought-out fashion; that they are provided with some continuity and consistency across the country and throughout the period of time children are in the government's care.

My problem with the 427 process is that the "protections" are so limited. I would like to ask the Committee to enhance the 427 protections by including requirements that universally are vital to maximize the safety of children.

1. We know that abused children can be injured or neglected by caretakers if they are not regularly visited by children's social workers. Clearly minimal standards of visitation are a basic protection.

2. We know that children can be left in the care of child molesters when criminal and child abuse background checks are not completed. This should be a required protection.

3. We know that reasonable efforts to prevent placement is a meaningless concept, unless comprehensive family preservation services are uniformly available. Family preservation should be highly structured and available.

4. We know that without training, education, housing and employment, emancipating foster youth often find themselves homeless and supporting themselves through prostitution and crime. Basic requirements for preparation for independence are essential.

5. We know that children with complex medical and developmental problems can be adopted with specialized adoption subsidies.

6. We know that children's social workers who are carefully trained in risk assessment are less likely to allow children to remain in danger. This training should be a basic protection.

In addition to these recommendations, I would like to suggest the following:

1. Block Grants of Categorical Discretionary Programs

Some block grants would work and benefit states and counties. For instance, there are 15 categorical discretionary programs under the jurisdiction of the Education and Labor Committee, which I believe should be analyzed as candidates for a block grant. Some, like the Grants to improve the investigation and prosecution of child abuse cases, are small - only $1.5 million appropriated in FY 1995. Others involve highly specialized programs, such as Crisis Support Centers. I believe we can more efficiently and effectively administer such programs and respond to local needs through a single block grant of these items, perhaps through IV-B.

2. Expand the Title IV-B and IV-E Waiver Authority

HR 5252, enacted in 1994, gives HHS the authority to grant ten waivers. This really isn't enough to be really innovative on a national level. I recommend consideration that this waiver authority be expanded to at least 50 or more, at least one for each state.

3. Increased Incentives for Adoption

Adoption is the preferred outcome for the children in foster care who cannot return to their own homes because of abuse and neglect. In Los Angeles County, in the twelve months ending September 1994, we placed more than one thousand children whose parents' rights had been terminated by the court in permanent and loving adoptive homes. Many of these adoptive placements could not have been achieved, however, without the Title IV-E Adoption Assistance Program.

To make this program even more effective, the concept of tax credits for adoption as an additional incentive for permanency for children merits analysis.

4. Program Integration

Last month, the Administration received comments on its Notice of Proposed Rulemaking, which would consolidate state plan requirements for several children's programs. I view this as a good first effort, but I recommend that consideration of it go even further.

As our Family Preservation program experience has shown us, we need an even greater capability for accessing additional programs and services for troubled families. Examples include Substance Abuse Prevention and Treatment programs, Housing, and Title XIX Medicaid to assure a full range of services for multi-problem families.

CLOSING REMARKS

In closing, I would like to re-emphasize that a commitment to child safety, protection and nurturance requires that all welfare block grant and child welfare block grant proposals be carefully analyzed for their effects on the safety and nurturance of children.

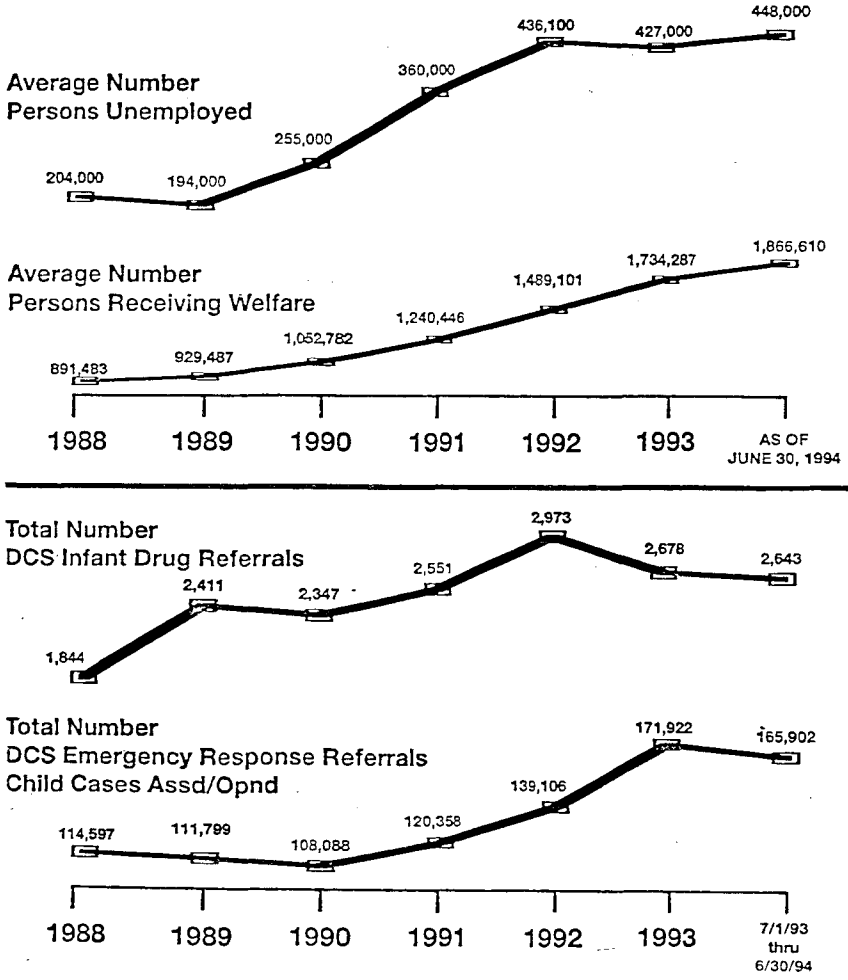
I'd also like to reinforce my conviction that national standards in child welfare and foster care provide the incentives and mandates for good practice, sound programs, and consistency for all children. Please enhance the standards for child safety. Please do not curtail them.

I have recommended a variety of ways for consideration to improve our child welfare policy, which would also provide to states an improved ability to deliver critically needed services.

I am honored to have had the opportunity to contribute to this crucially important discussion. I remain available to work with you in your efforts towards improvements in protecting children and strengthening families.

I am in awe of the magnitude of the decisions you must make since they will effect the well-being of millions of children.

Unemployment, Welfare, Infant Drug Referrals, Emergency Response Child Cases and Child Placement for Los Angeles County



Chairman JOHNSON. Thank you for your very interesting, useful testimony.

Mr. Murphy.

STATEMENT OF PATRICK T. MURPHY, ESQ., COOK COUNTY PUBLIC GUARDIAN, CHICAGO, ILL.

Mr. MURPHY. Since 1968, I have been litigating issues involving abused and neglected children at every level of the State and Federal Judiciary. Since 1987, I have been Cook County Public Guardian running an office of about 135 lawyers and 60 socialworkers and investigators representing primarily abused and neglected children, again at every state and level of the judiciary.

Secretary Bane pointed out that the 1980 Adoption Assistance Act improved the whole system of child welfare in response to a question from Mr. Levin, I think. Based upon my own experience, I testified twice before Senator Birch Bayh's committees leading up to this act and in favor of it. I wrote a book in 1974 where I said we needed more family preservation programs. All I can tell you is, based on my experience, things are much worse today than they were before the 1980 act, and I am not suggesting the 1980 act caused everything to get worse, but indeed they are much worse.

If you look at Chicago in 1986, there were 8,000 kids, neglected and abused kids in custody. Today, there are over 30,000. Nationwide in 1986, there were 262,000; today, over a half million.

Mrs. Johnson referred to the crack epidemic as causing this and 80 percent of our cases in Chicago are crack related. But what causes people to turn on to crack? In our judgment and what we see every day, it is the woman who is 22 years old, who has five children by different fathers, and none of the fathers are dads. She wakes up and she is depressed. She has got no education. It is a reality-based depression and she turns to drugs the same way you and I would if we were in the same situation.

We can get in a plane and go to L.A. or San Francisco or the shore of Michigan. These people cannot. They are stuck in the inner cities. They are stuck with the children without an education and no place to go, so they turn to drugs. Their paramour is the drug supplier and he abuses the kids and abuses the woman and that is what we see in the system.

The simple fact is that you cannot look at the child welfare system in our major cities without looking at what causes it. And what causes it is the underclass and that is what we see feeding into it. Ninety percent of the cases we see, probably closer to 100 percent some weeks, are the children of the underclass.

And again, Mrs. Johnson referred to the case in Chicago of the 18 children. Actually, it was 19 kids and these 5 women had 23 kids amongst them. We represent them. We are their lawyer. And the 23 kids had 17 fathers. And each one of these mothers had their first kid when they were between the ages of 14 and 16 because we have a welfare system which encourages irresponsible behavior.

If you look at the family preservation program, who do we reward? The 95 percent of the people in the underclass who do a good job under difficult circumstances of raising their kids? No. They don't get a farthing. But if you abuse your kid, we will run out with

a socialworker, a housekeeper, a psychologist, chauffeuring services, and money. It makes absolutely no sense, but that is the way our welfare system has been conducted in this country and we see the failures of the welfare system in the juvenile courts.

I would just say beware of wolves in sheep's clothing who are going to come before you and they are going to say we need continuation of the same thing. And these people are academics and they are foundation people and they are government people whose livings are being made from this private and public welfare complex.

There are two types of politicians, I think, responsible for this, if I can lecture such an austere group of people, and that is Conservatives who have given over the responsibility for dealing with the poor to the Liberals, and the Liberals who haven't had a—and I perceive myself as a Liberal Democrat, by the way, though I think Liberal Democrats don't, but the Liberals who haven't had a creative thought in 30 years. And I think we have to come together to try to figure out ways of dealing with this very complex problem.

To use an example, Marianne Wright Edelman, who should know better, wrote in Mother's Day and Parade Magazine, if it is wrong for 13-year-old inner-city girls to have babies without the benefit of marriage, it is wrong for rich celebrities, too. Absolute garbage. A 35-year-old woman with a lot of money can raise a kid by herself but a 12-year-old kid or 14- or 15-year-old kid should be reading Chaucer, should be going to sweet shops, and should be doing other things. All I can say is I go to court, my 9-year-old kid is here with me today, not as an exhibit but because he wanted to get out of school. That is probably a form of child abuse.

Mr. LEVIN. Just a normal kid.

Mr. MURPHY. And I walk into court and I see kids the same age as my 9 year old and my 12 year old and I know they have the same ability and talent, but unless they can do the 40 in 4.1, we don't care about them. We are willing to spit their lives down the drain and that is what we are doing with the lives of the kids of the underclass.

And the way to do something about it isn't to give them more money. If I gave Joe $150 every time he broke a window, he would go break another window. If you give a 12-year-old kid AFDC because she has a child, it is cultural. What do you expect? We have got to change the system. We have got to rethink it. I don't have the answers. I am just a lawyer who goes to court. But we have to think about the answers and come up with conclusions. Thank you.

[The prepared statement follows:]

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TESTIMONY OF PATRICK T. MURPHY BEFORE THE COMMITTEE ON WAYS AND MEANS, SUB-COMMITTEE ON OVERSIGHT JANUARY 23, 1995

The Cook County Public Guardian's office acts as guardian for 400 elderly people who suffer from Alzheimer's disease and organic brain syndrome and also as attorney and guardian ad litem for 31,000 abused and neglected children in Cook County, Illinois. We have 250 employees 35 lawyers and about 50 social workers or investigators. The vast majority of our lawyers work in the Juvenile Court in Chicago.

I personally have been representing abused and neglected children since 1968 first as a legal services lawyer, then in private practicing and since 1986 as Public Guardian. I have argued cases involving abused and neglected children and their families at every level of the state and federal judiciary, including the United States Supreme Court. In 1974 I wrote a book about my experiences in representing abused and neglected and their families--Our Kindly Parent the State, Viking Press, Penguin Books.

In that book, and later on at least two occasions before Congressional committees, I argued that the poor were being victimized by the state's approach to child welfare. Along with others, I argued that family preservation would be

cheaper for the government and better for the child. In my experience in the 1970's cases of actual child abuse were rare. We argued that most children were taken from poor parents because of the middle class bias of state social workers.

In 1980 congress passed the Adoption Assistance and Child Welfare Act ("AAA"). This act mandates that the state provide family preservation services to keep children at home. In Illinois, for instance, these services have taken the form of housekeepers in the home, cash vouchers up to $500, a downpayment of two months rent on an apartment, psychiatric or other counseling and chauffeuring services. The Adoption Assistance Act was the culmination of the "do not blame the victim" philosophy popular in the late 60's and 70's. According to this viewpoint, a poor, powerless and misguided parent is as much a victim as the child whom he or she has abused. According to this thinking, the state should provide services so that parents can learn to provide adequate care to their children.

Because we represent abused and neglected children, primarily at the Juvenile Court in Chicago, we see life from the bottom of the mountain, not the top. I cannot pretend that our perspective is that of an administrator or a bureaucrat or an academician. We are lawyers going to a specific court in a specific county, in a specific state trying to represent, as best we can, 31,000 children who range in age from a few days old to swaggering, defiant and down deep frightened adolescents. We cannot tell you first hand the effects of the 427 reviews. However, we can tell you first hand that they appear to make no difference, other than to increase bureaucracy.

In brief we believe that the 427 Review should be done away with because:

(A) experience shows they do not help;

(B) over the past two decades, the philosophy these reviews seeks to uphold has been shown to be not only muddleheaded, but positively counterproductive, in that it harms the very people it seeks to help, and

(C) anything we can do to reduce federal bureaucracy and to return decision making to those who actually face these problems is a step in the right direction.

Let's take an actual case. On September 15, 1994 Chicago Police charged a 31-year-old woman living on the Westside of Chicago with endangering her nine children, age six weeks to adolescence. The police reported: "[e]ach child smelled of human feces, there was inadequate cleanliness, inadequate food, roach infested conditions and two inches of water in the house." The Illinois Department of Children & Family Services (DCFS) had been "working with" the mother for the past half dozen years. After the police took the kids from the woman, a DCFS spokesperson said: "From the time we've been involved with the family, we've been dealing with issues related to poverty...we can't take children away just because of poverty, and just about everything here...relates to poverty...."

Four years earlier, DCFS, with Juvenile Court approval, had taken the kids from the mother because she left home to get her welfare check and didn't think of coming back for two days. Her six children were left with an invalid grandma. According to investigators, at that time the four children:

> were without coats. Poor hygiene...standing water...soiled pampers throughout bedroom floor. Holes in walls and falling plaster....Older children

> admitted they had not had any breakfast for two days, only lunch at school and a sandwich for dinner. Infant was saturated with urine when child was taken into protective custody. Worker changed pamper and baby was so raw from diaper rash, skin literally came off in diaper. There was no food at all in the refrigerator, all baby formula was spoiled even bottle child was drinking from....

After a few months, DCFS returned the kids to the custody of the mother and began to offer her family preservation services. The State provided the mother with a housekeeper five days a week. They purchased beds and hired workmen to install a hot water heater and fix the holes in the wall. Somewhere along the line, however they forgot to make sure that the mother kicked her habit. Not surprisingly, four years later, the kids were in worse shape and there were three more of them.

I could write pages about the number of kids I have seen beaten, raped or killed while the state was trying to preserve a family that was not a family at all, but instead a couple of people whose sexual relations led to the birth of a child. In my view from the bottom of the mountain, at a collectively unconscious level, society simply does not consider the underclass kid to have the same worth as a white or black middle class child. These poor children are fungible commodities to be experimented with by sending them back to parents who have tortured or neglected them.

The child welfare crowd frequently takes a blasé attitude toward child abuse. Take a recent study[1] that divided all injuries suffered by children into four

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[1] NATIONAL INCIDENCE AND PREVALENCE OF CHILD ABUSE AND NEGLECT: 1988, Revisited Report, Rockville, Maryland, Westat, September, 1991,

categories: Fatal, Serious, Moderate and Inferred. Moderate was defined in the report as "injuries or impairments for which observable symptoms persisted for at least 24 hours (e.g., bruises, depression or emotional distress.)" The authors of the report listed only six percent of all sexual abuse cases as serious, even though one third of all sexual abuse cases included penile penetration.

Therefore, the majority of cases where your friendly pervert screws a child are not serious. And it is only "moderate" sex abuse when the mom's paramour or the dad comes up behind a 12-year-old girl and fondles her breasts, or pats her butt, or bites her on the shoulder, or strokes her leg or crotch as they're watching MTV. And it's only moderate sex abuse when in one third of cases the lout actually screws the kid. But the true believers in the child welfare industry argue that these adults are victims who must be helped at the expense of the child's safety.

Could you imagine the response of feminists (or conservative, traditional women, for that matter) to anyone arguing that this type of behavior toward a nonconsenting adult woman is not serious? Or try suggesting that a boss who i mouthing sexual innuendos is not guilty of a serious infraction. Or that a goon who slaps his wife or girlfriend around leaving "injuries or impairments for which observable symptoms persisted for at least 24 hours (e.g., bruises, depression or emotional distress) causes only "moderate abuse." Beat up or rape the kid down

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as reported by Douglas Besharov and Lisa Laumann in a paper prepared for the Woodrow Wilson School of Public and International Affairs, Princeton, New Jersey, May 25-27, 1994, DON'T CALL IT CHILD ABUSE IF IT'S REALLY POVERTY.

the block and you'll end up in the can for a good long spell. Beat up or have sex with your own child and you'll get a social worker and housekeeper.

And the federal guidelines mandate that even when the children are taken away, the states must bend over backwards to send the children back home. Let me give you one more case of ours, but I'll let the Chicago Tribune explain it:

> A mother who stood idly by as her boyfriend repeatedly sexually and physically abused her three daughters, including one who later died, should be flown at taxpayer expense to Florida four times a year to visit her two surviving girls, [DCFS officials] are recommending.
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> ...
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> At the trial, testimony showed that [the mother] for years stood idly by while as her three daughters were beaten and raped by [the boyfriend]. In some instances, she had been in the same bed with [the boyfriend] as he sexually attacked her daughter, according to the testimony.

(The daughters were four, six and eight at the time that the younger one was murdered by the boyfriend.)

The 427 Review for family preservation is a great idea if there is a family to preserve. But, it is a horrible idea if it involves keeping children in returning them to a situation where they can be seriously harmed. The goal of child welfare should be child protection. At times, child protection means preserving the family. But federally mandated child preservation too often means that services are lavished on irresponsible individuals who have seriously harmed their children.

Family Preservation also makes little sense in the larger scheme of welfare services. Under its aegis, irresponsible behavior is rewarded and responsible behavior is denigrated. If, for instance, you take any floor of any housing project in

the nation you may find seven families struggling heroically against impossible odds to raise their children adequately, three or four families providing marginally for their children, and one or two crack cocaine addicts who abuse their children or leave them kids alone while they go out looking for drugs. Which of the parents receives additional services from the tax payers? Not the seven families providing heroically for their children or even the families who are providing marginally care. Instead, the drug addict actively abusing or neglecting her children may get a housekeeper, money, intensive social work services, chauffeuring, to appointments and even several months rent for a new apartment, so that she can move out of the projects.

The message to people in the underclass is; act irresponsibly and you will get help. Act responsibly and you get nothing. I submit to you that this is a patronizing message. Because it involves the underclass, which in our major cities is comprised primarily of African American, it is a racist message.

These vignettes are anecdotal. But Chapin Hall at the University of Chicago conducted a massive three year study of the Illinois family preservation program--Family First. The study was the largest and most comprehensive ever performed on a family preservation. Chapin Hall concluded that Family First did not have any measurable success at keeping children out of the foster care system. Because the program cost $20 million dollars a year, the Chapin Hall report concluded that DCFS was spending $20 million to save $2 million, in effect wasting $18 million a year. In the best tradition of bureaucracy, the agency then sought to expand the

program.

Chapin Hall reported that DCFS officials recognized that the Family First initiative would lead to deaths of some children, but apparently believed that the successes would outweigh these setbacks. Chapin Hall pointed out that "It is almost certain that the probability of child deaths will be higher in a program in which children at risk are left at home rather than taken into foster care..." The report goes on to observe, "The original designers of the [family preservation program] realized that such cases would occur and went to some lengths to devise responses to these crises." As a part of its evaluation process, Chapin Hall began gathering data on the deaths of children during and after Family First services were offered. However, Chapin Hall reported, that after a year or so, "DCFS administrators have asked us to suspend our study of child deaths."

DCFS gives security deposits and rent downpayments to people whom the agency perceives to be in danger of losing their children because of inadequate housing. This is a reasonable program if funds are not given to parents who have blown the egg money on crack, coke, heroin and booze. When Chapin Hall began to study the housing initiative, DCFS again told them "to halt all inquiries...."

Who are the children and families we see at court?

In 1986, 8,000 children were in substitute care in Cook County as a result of abuse and neglect. Today, there are over 30,000 such children. In 1986, 262,000 children resided in substitute care, while today there are about half a million. Most child welfare experts attribute this astounding increase to drug

abuse. At least 80% of the cases we see in Cook County involve a drug addicted parent or parents. Lawyers in L.A. and New York tell me that their statistics are the same or higher.

At first I thought that drugs were the cause of the dramatic increase in child abuse, but not today. The usual case we see from the bottom of the mountain involves a woman in her earlier 20's with three to five children by several fathers, none of whom is involved with her or the kids. She becomes depressed and her depression is reality based. She is a high school drop out with little education and no job prospects. Her own mother had her first child when she should have been studying Chaucer or skipping rope. And she herself does not know her father. She wakes up one day realizing that for all intents and purposes her life is over. And, probably so too are the lives of her children. She turns to drugs as a reasonable, cheaper and certainly more viable alternative to a trip Vermont, the shore or Europe. And if you or I were in her shoes, we would turn to drugs or worse.

She becomes more depressed, withdrawn, forgets her children and goes off for hours, days, and even weeks leaving her kids for neighbors and family ultimately to rescue. In many cases her drug supplier becomes her paramour and ultimately the abuser of her children.

The underclass was not created by welfare, but today it is sustained by a welfare system that encourages dependency. The problems of the underclass are exacerbated by the flight of companies to underdeveloped countries. To succeed today, you need at least a high school diploma and probably more. Children having

children do not finish their high school education. People of the underclass do not have the high school education plus more. The Right ignores the plight of the underclass and the Left patronizes it, which is just another form of racism. Marion Wright Edelman of the Children's Defense Fund, who knows better, wrote in Parade Magazine on Mother's Day, 1994, "And if it's wrong for 13-year-old, inner city girls to have babies without benefit of marriage, it's wrong for rich celebrities too." The fact is, most single women celebrities who are having children are not children, and they have the maturity and financial resources to raise a child reasonably well. Thirteen year old girls should be doing math, playing volleyball, and working on computers, not changing diapers and worrying about their W.I.C. funds, AFDC checks and food stamps.

Every Sunday afternoon, I see large African American men running up and down the gridiron, knocking other men down and scoring touchdowns. Colleges and professional teams demand excellence from inner-city African American athletes. Society, schools and the Left expect nothing from inner-city African American kids, whether bright, average or dumb. The most depressing part of my job is to walk into juvenile court on any day, and to see kids about the same age as my own two sons, with the same potential for excellence and achievement, who will never have the chance to attain that potential. As a society, we should demand excellence from everybody, but most particularly from those who have no one else to motivate them to reach their potential.

I compare the underclass I see in court today to the poor I represented in the

60's and 70's, and the comparison is invidious. I now see five or six generations, 15 years apart, of welfare dependent families without constant male authority figures; schools that do not--and cannot without parental involvement--educate; factory jobs exported to Asia; a welfare system depriving people of dignity, fostering irresponsible behavior and belittling self-discipline; drugs sold on street corners as freely as soda, and guns as available as drugs; and the whole mess a Gordian knot resisting solutions and ready to explode in the outer cities as random violence and in the inner city as rioting and looting.

A New York Times' journalist points out that "while the cost of welfare is not small, it is not as large as the passions that surround the issue...."[2] The cost of AFDC may not be astronomical, but it is devastating in terms of spinoffs such as children who ultimately end up in the criminal justice system, who are abused and neglected, or who simply live out their lives in despair on welfare themselves. To understand the underclass and the problems of the underclass, legislators, members of the Administration and other politicians should not read boring statistics which can be argued every which way. Instead, they should spend a few days, weeks and even months in our criminal and juvenile justice courts in any moderately sized city.

The Democrats have predictably blamed Ronald Reagan, who has become the liberals' favorite whipping boy for all the social ills facing our country. Reagan was not exactly Oscar material, either before or after he was elected president, but

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[2] New York Times, December 5, 1993.

I suppose it is only fair that the liberals place the blame on him for the underclass because conservatives have excoriated L.B.J.'s expansive and "irresponsible" programs for the same problems. But it does seem just a bit much for the liberals to shirk their own responsibility, when it was we, liberals, who hushed up the Moynihan report, when he warned us of the coming underclass syndrome almost three decades ago.

The Moynihan report was one of the earliest victims of political correctness. Moynihan pointed out what he perceived to be an alarming statistic--that 25% of all black children were being born to single moms. He also prophesied that the implications of this report could lead to increased misery among very poor African Americans. In other words, although he didn't call it that, he was alluding to what has since been tagged as an underclass. The Left would have no part or Moynihan or his report, both of which were labeled as racist. What they were really saying is that we cannot openly discuss the implications of this report because so many Americans are racist, and they will surely take these statistics to mean that African Americans are somehow less stable, less moral, less ethical and less family oriented than their white counterparts.

Instead of admitting to the problems of the underclass and welfare dependency, the Left purposely misstated the statistics, arguing that the majority of individuals on welfare are white. Of course this is true, but the vast majority of Americans are also white. When the statistics are studied realistically, it is clear that a welfare dependent, primarily African American underclass wallows in misery.

The Bane/Ellwood studies show that when first time recipients of AFDC are broken down by race, 60% are white, 35.7% black. At any one time, 48% of recipients are white and 47.5% are black. With respect to the percentage of individuals who receive AFDC for more than ten years, 15% are white, and 33.7% are black.

Most of the cases we see in Juvenile Court involve the underclass. Because in our major cities the underclass is primarily African American, the majority of our abused child clients are black. The problem is not racial, but neither is it economic. It is cultural. A culture of welfare dependent individuals recycle their welfare dependency and misery to a new generation every 15 years or so, and that population, for reasons dating back to slavery and segregation, is primarily African American. If we do not stop now, examine the problem and, as a society, try to do something about it, it will explode to haunt the rest of us and our children for generations to come. Worse, we as a society are flushing the lives of many potentially talented human beings right down the toilet. But forget the talented human beings, why should a decent society shove aside innocent children, talented or otherwise, because they come from a certain background?

In an article written for the Chicago Sun Times, The ACLU argued that welfare reform could be unconstitutional:

> The child exclusion is not about saving money:
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> > it is about singling out poor children for punishment because of the decisions of their parents. The goal of child exclusion proposals, as outlined by its proponents is to coerce 'welfare mothers' into not having children. But just as the government cannot outlaw abortion and require women to bear children, the government cannot prevent

women from having children.[3]

The goal of welfare reform should not be to prevent women from having children, but to encourage teenage girls to make decisions based upon microeconomic realities and to delay child bearing until they are adults who are capable of supporting their children. The ACLU argument that poor children are being singled out for punishment is garbage. AFDC checks go to moms, not kids. These mothers make decisions how to spend the money and live off the checks as much as the children, and some times more. Most mothers receiving AFDC checks do use the money for the benefit of their children. But welfare cast as a children's issue makes questions of welfare dependency disappear.

CONCLUSION

Children, primarily from the underclass, are pouring into the Juvenile Court and child welfare bureaucracies, primarily because of the failures of our welfare system. I implore you to devise ways to cut down the federal bureaucracy and guidelines, which stifle creative thinking on the local level and which seem to exist only to uphold a politically correct philosophy, which no longer make sense.

The child welfare bureaucracy and its supporters are already turning up the heat, arguing that reform will harm children. The reality is that children are being harmed <u>today</u> by a welfare system which rewards irresponsible behavior and fails

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[3] Article from the Op-Ed Column of the Chicago Sun Times, June 25, 1994, by Deborah Lewis, Legislative Counsel for the Washington, D.C., legislative office of the National American Civil Liberties Union.

to encourage teenagers to pursue educational goals and to escape the underclass through persistence and hard work. Children are being harmed today by a child welfare system which rewards parents for irresponsible behavior towards these children, by keeping these children in the homes of abusive parents.

And please do not forget that those who complain the loudest have financial incentives to do so. Child welfare is a major industry in this country. The Department of Children and Family Services in Illinois receives over one billion dollars a year in taxpayer support. Those who argue loudest against welfare reform more often than not earn their livings as part of a private/public welfare complex. President Eisenhower's 1960 dictum concerning the evils of a military/industrial complex today can be applied equally to public and private welfare and child welfare elites today. These individuals hide behind abused and neglected children in an attempt to keep the money flowing into their own coffers.

Chairman JOHNSON. Thank you very much, Mr. Murphy.

Ms. Barr, I would like you to describe in a little more detail your State's oversight system, because you mentioned that there are three different systems. You have to do certain things under section 427 that you don't normally do. But in your testimony, you describe in rather more detail what your State actually does and it sounds to me very sensible and appears in practice to have been very effective. So what do you do and what is the contrast between what you do and what 427 would have you do?

Ms. BALASCO-BARR. Section 427 requires us to do the division-directed case reviews that alternate with the court when there is court supervision of out-of-home placement. The Child Placement Review Board works from the judiciary system. It is a group of volunteers who are located in each county in New Jersey and they, too, review out-of-home placement cases and hold informal hearings regarding those same children. My point was that there are three bodies then reviewing the same case.

Chairman JOHNSON. What is your success with the volunteer review process?

Ms. BALASCO-BARR. It is—I value that, because oftentimes we get tied up into what is good case practice and sometimes forget what is good common sense and oftentimes the volunteer perspective brings to the case review process very good basic common sense. And that is the value of having lay volunteers reviewing the cases who are vested solely in what is good practice and what makes good sense for this child.

Chairman JOHNSON. Very interesting.

Mr. Murphy, do you believe that this kind of citizen review board random outcomes testing, random intervention would be better than the bureaucracy that we have now? Might it enable us to reach these problems earlier or manage them more efficiently?

Mr. MURPHY. I think we are just kind of playing around with something like a shell game, as I think maybe my testimony implied. I just think the whole system needs total rethinking. There should be more local control. Where the money comes from is something I am not an expert on. But I think that the control and the direction should be on a very local basis.

Chairman JOHNSON. Thank you. Mr. Matsui.

Mr. MATSUI. Thank you. I would like to just say, Mr. Horn, welcome back, and Mr. Murphy is making you look like a Liberal. I want to thank both Ms. Barr and certainly Peter Digre is a good friend and somebody that we have used often as a resource. We appreciate your coming from Los Angeles.

Mr. Murphy, I would like to ask you a question. You have 135 lawyers, you were saying, in your operation, your division, I guess it is?

Mr. MURPHY. Yes.

Mr. MATSUI. And you are in charge of making sure that well, you are a guardian for children, right, you are a court-ordered?

Mr. MURPHY. No. The public guardian name is a misnomer. We act as a guardian for elderly people in one small division. We take care of them and their estates. Our largest division, which I took over in 1987, there were 12 lawyers when I took it over, now there

are 135, and there were no socialworkers. Now there are about 60. We act as lawyers for children in that division.

Mr. MATSUI. So 135 lawyers under your jurisdiction——

Mr. MURPHY. That is correct.

Mr. MATSUI. You have jurisdiction over children? You are the lawyers for the children?

Mr. MURPHY. That is correct.

Mr. MATSUI. In other words, you are the guardian—then your department, I guess it is, is a guardian for these children?

Mr. MURPHY. We are their lawyers.

Mr. MATSUI. And this is how many thousand, 30,000?

Mr. MURPHY. Thirty thousand.

Mr. MATSUI. It started with 8,000 in 1980; it is 30,000 now?

Mr. MURPHY. Correct.

Mr. MATSUI. Now, this is the State. In other words——

Mr. MURPHY. The county.

Mr. MATSUI. In other words——

Mr. MURPHY. Chicago and its suburbs. The city of Chicago and its suburbs, about 6 million people.

Mr. MATSUI. Right. And you indicated—Chairwoman Johnson mentioned the 19 children that were left abused. And then I recall back in—if I am not mistaken, back in 1993, if I remember, in February or March of 1993, there was a situation where a mother had, I believe, killed her child?

Mr. MURPHY. That is correct.

Mr. MATSUI. We had a hearing about that.

Mr. MURPHY. That is correct.

Mr. MATSUI. In Chicago, if you recall, that some of us were interested in.

If you are the guardian and you have 135 lawyers, why is it you are not able to deal with these problems? Because it would appear to me that as guardian, you have a personal responsibility to making sure that these children are taken out of that kind of a situation. Why did that happen?

Mr. MURPHY. Well, we are the lawyers. Again, we are not the State agency which usually appears, which is the guardian. And what we end up doing is suing the State agency. We have won over 1 million—I won't go into all the lawsuits we have had against them.

One of the frustrations I feel, though, is when I came on board in 1987, I thought that suing and, as I said, we won all kinds of cases, would bring about reform. What you realize after awhile is that——

Mr. MATSUI. If you can answer my question, because you are—I have to understand this. You say you sue State agencies, but you do that on behalf of a particular child. Is that correct?

Mr. MURPHY. That is correct.

Mr. MATSUI. So if that child who was murdered by the child's mother, why did you not—you were the guardian of that child.

Mr. MURPHY. We were the lawyer. That is a good case, because that is a case where I think our lawyers goofed up and it was a family preservation case.

Mr. MATSUI. What lawyer goofed? Not your lawyer but somebody else.

Mr. MURPHY. Me. I think I goofed up in that case because I am responsible for the lawyers under me. This is a case, a good case to talk about, where a mom who spent years in a psychiatric facility was doing disgusting things. She was eating glass, sticking bottles into her, that's where the State came in and said that we want to keep the kid with the mom.

Mr. MATSUI. Right.

Mr. MURPHY. We ultimately went in and argued the kid should not live with the mom and we lost the case and we refused to appeal it thinking that we couldn't win. It came to court the second time and we agreed with the State the second time that this was a great family preservation case, we should put a housekeeper in the home. There was a housekeeper in the home 7 days a week. And the woman turned out and murdered her child. It is a good example of family preservation gone crazy, and we were as much to blame as the State in that case in agreeing to it.

Mr. MATSUI. And this is just the point I want to make, because this was a State-operated program.

Mr. MURPHY. That is correct.

Mr. MATSUI. In fact, what you are doing now is under State operation at this time.

Mr. MURPHY. No, no. It is a federally—don't forget family preservation came from the Adoption Assistance Act and it came from the 19—that is where it came from, right? So that Illinois was reacting and they had a special $20 million grant from the Feds to do this.

Mr. MATSUI. No, no. What I am talking about here is that your department is a State-operated——

Mr. MURPHY. County.

Mr. MATSUI. County, excuse me.

Mr. MURPHY. It is government operated.

Mr. MATSUI. I guess we just talked about the 19 children that were left.

Mr. MURPHY. We were not involved in that until they came into the system, of course. We were not their lawyers when they were living out there.

Mr. MATSUI. Doesn't this point out the problem with the entire system and the fact that here you are—you are running it. You are the one that should be in charge of this.

Mr. MURPHY. I am in charge of the lawyers——

Mr. MATSUI. It is one thing to rail about how terrible the system is, but what specific steps are you taking right now to try to deal with it? How can the Federal Government help you with this? Because we are having the same discussion that we had 2 years ago, and you are still doing the same thing but you haven't come up with any solution.

Mr. MURPHY. The solution—the solution is this, is that you and I are talking about lawyers going to court and socialworkers——

Mr. MATSUI. No, I am not. You are talking about that. Tell me what recommendations you would make specifically to us so that we can pass legislation to make your job better and make sure those 19 kids aren't in a position of disrepair and that young child doesn't get murdered?

Mr. MURPHY. You should put me out of business.

Mr. MATSUI. We would like to put you out of business, for good reasons.

Mr. MURPHY. Mr. Matsui, I know I am in Congress here, but you asked me a question. I would like an opportunity to respond.

Mr. MATSUI. I don't want a filibuster. I just want you to answer the question.

Mr. MURPHY. I will.

Mr. MATSUI. Good.

Mr. MURPHY. And that is my own agency has gone from 12 lawyers and no socialworkers to 135 lawyers and all these socialworkers in just a few years. The State DCFS office has tripled its budget in a few years. There was a prognostication by Secretary Bane that maybe things will level off. I will tell you they will double in our major cities in the next 5 years. Why? Because no matter what you do within the child welfare system, it will have no effect because the child welfare system is a product of the underclass and of our welfare system, which is in total disarray. So no matter how many billions and experts and socialworkers you pour into the child welfare system, it doesn't mean a thing, because as long as you have 14-year-old kids having kids, which no lawyer, no socialworker, no bureaucrat, no Congressman can do anything about, as long as we say we don't care if you get an education or not, we are going to continue to reward you, the system is going to be in disarray. We have got to change our welfare system and take a look at what—who we are encouraging.

You know, the real problem is that—I know the Democrats like to blame Reagan and the Republicans, Johnson, but no one listened to Pat Moynihan in 1966 when he prognosticated what was going to happen when kids were having kids without the benefit of fathers. We see it every day in juvenile court. That is what we have got to address.

Mr. MATSUI. Let me say this. I think you are getting to the root cause of our problem. And again, I shouldn't say root cause. But you are getting to the fundamental problem that we are trying to deal with here. But given the fact that we are trying to deal with the welfare system and that is in the same general area but on a separate track at this time, we still are talking about the child welfare system at this particular time and just to suggest that we just throw it out is——

Mr. MURPHY. I am saying not throw it out.

Mr. MATSUI. What are you suggesting, then?

Mr. MURPHY. I am saying unless you concentrate on this bigger welfare system of the underclass, it doesn't make a difference what you do with child welfare. You can run it from Washington, you can run it from Springfield, you can run it from L.A., you can run it from Mogadishu, it doesn't make any difference because we are feeding into it from the underclass and it is the underclass that you have got to attack. You have got to attack that problem because it will make no difference. We are going to double the size in Chicago, I can tell you, in 5 years.

Mr. MATSUI. Let me just conclude by saying I tend to agree with you. I tend to believe that the problem is going to get worse and worse. And we have a long ways ahead of us.

Mr. MURPHY. Because the underclass is growing.

Mr. MATSUI. I would like to thank all four of you. I am sorry I didn't get a chance to ask you questions. I do appreciate and look forward to working with you.

Chairman JOHNSON. Thank you. The panel has really given excellent testimony.

Mr. Hancock.

Mr. HANCOCK. Thank you very much. Mr. Murphy, I read the last paragraph in your statement. I would like to get a response to the statement that you make that this is a major industry, that actually it is to their benefit to increase the number of people on welfare because that is the way they make their living.

Would you like to make a statement on that?

Ms. BALASCO-BARR. I appreciate the opportunity to make a response to that, because when—I think we can get so overwhelmed by the numbers of what not—what is not working that we don't take the opportunity to look at where in States family preservation is working and where there has been decreases in the number of children coming into foster care and what model programs are working in several States, three of which that I know of personally because I was there. In Michigan with the Kellogg Foundation, looking at neighborhoods, building neighborhoods, changing neighborhoods, helping communities become more responsible for the children and families that live in those communities; Governor Whitman with her urban initiatives going back to the center cities, empowering communities, empowering church groups, empowering small neighborhoods, small groups to be responsible for the children that we have to serve, finding different ways that don't involve children going into foster care but still require the State or the city to spend money to help people improve their housing, improve their child care, improve their education programs, having substance abuse programs that serve people where they have to learn to live.

Mr. HANCOCK. Pardon me. It sounds to me like you are talking volunteerism. You are talking about getting people involved in this area whose personal income is not necessarily tied to our welfare programs. Am I correct in that statement? Mr. Horn, would you like to make a comment?

Mr. HORN. At the risk of no longer appearing Liberal to Congressman Matsui, I would like to——

Mr. MATSUI. I ruined your reputation, I am sorry.

Mr. HORN. I think that one of the points that Mr. Murphy is making is a very important one, which is that when you separate out, particularly biological, fathers from the household, what you get is an extraordinary increase in the potential for abuse. By one study, the estimate is that abuse goes up 40 times when biological fathers are out of the household.

Now, there are lots of reasons for that. One is there are less resources for the family. The second is that parenting is less public. There is not a partner to help you. The third is you tend to introduce nonbiological males into the household and that can be a very dangerous situation.

The fact of the matter is there is a great deal that can be done to improve this situation through child welfare reform and also welfare reform. Unless fathers start to take their responsibilities

more seriously and more men are in the homes to raise these children along with the mothers, unless we change that culturally, we are going to see exactly what Mr. Murphy predicts, which is a rising caseload in child welfare.

One of my complaints about the current system is that there are so many games States and local agencies have to play in order to access money for very specific purposes, that there are few resources left to address this problem, the problem of fatherlessness. One solution is to say OK, let's start a new fatherhood program. Let's appropriate $100 million and go out there and support fathers. Well, that is the wrong way to go. The right way to go is to give States and local agencies flexibility, and if, in fact, fatherlessness is an issue in their community, let them use the money to address this problem.

Now, to the issue of whether there are people getting wealthy off the child welfare industry. Certainly there is a lot of money in child welfare and there are people making money off child welfare. But I don't think there are a whole lot of millionaires who are running around because of funding streams that are coming from Washington for the child welfare system.

But clearly the incentives are wrong. Mr. Murphy is right, the incentives say abuse your kids, you get lots of services. But if you stay in school, you don't impregnate a girl, and if you do, you get married and you get a job, then where are the support systems for that family? We need to change the way that we do things fundamentally to encourage much more positive family life and parenting.

Mr. HANCOCK. What you are saying basically is it is going to have to be done through an educational process or a reeducational process that the male does have responsibilities in addition, because I don't think the schools are teaching that now. They are saying, we will provide you the equipment and encourage you to have sex.

Mr. DIGRE. Yes. I think Mr. Murphy created a misimpression in terms of the nature of people that I see flooding into the child welfare system. We had a real good case study in California in that our AFDC grants were cut twice in the end of 1992, and what we saw coming into the child welfare system was people who lacked the basic essentials of life: Food, clothing, and shelter.

We saw a vast—40 percent of all the people who came into our family preservation programs were there basically for the reason that they simply could not find housing. And so it is not—certainly there are many dangerous people who should never be—have access to their children and never be reunified with their children. But there is also a huge proportion of people who end up with kids in the foster care system who simply lack the wherewithal to raise their own kids. It gets down to those very specific issues about a place to live, food on the table, medical care, and things like that.

So I thought that was—that was much too strong a statement about the nature of the parents that we see. And I would invite any of you to come to Los Angeles to sit in one of our family preservation programs and talk to several dozen parents in a family shelter and judge for yourself whether there is hope for their futures if they can be stabilized in the economy.

Mr. HANCOCK. Thank you, Madam Chairman.

Chairman JOHNSON. Thank you. Now we go to Mr. Herger.

Mr. HERGER. Thank you, Madam Chairman.

If I could just follow up, please, Mr. Digre. Could you tell—as I am listening to you, I believe you are stating that because these families, because of the economy downturn, they don't have enough money, therefore we are seeing these problems multiply. Could you tell the committee your estimate of how many families you would say in your experience that are losing their children solely because of not having enough money?

Mr. DIGRE. Approximately half.

Mr. HERGER. So solely for no other reason just that there isn't enough money.

Mr. DIGRE. Now, it is what Mr. Murphy talks about. People at some point start to give up. That is when you start to see the introduction of crack and other drugs. But, you know, there is a point at which I would say about half of the families are not physical abusers, not sexual abusers, not people with propensities to violence but simply people who are struggling to keep ends pulled together and are eminently salvageable.

One of the things we have done is we implemented our big, very comprehensive, intensive family preservation program in Los Angeles in 1993. We brought it up covering half the county, half the zip codes in the county but not the other half. So we have compared the two.

What we have seen is in those areas where we have a real package of supports, a very intense package of 23 services and 16 visits a month to keep families together, we have had no growth in foster care whatsoever. Where we have not had this program, we saw during that same time period in 1994 about a 20-percent growth in the foster care population. So we saw about a 20- to 25-percent difference whether or not these were available. And what we found time and time again, what people were struggling with was the food, clothing, and the overriding issue of shelter and to back that up things like drug treatment, employment help, things like that.

Mr. HERGER. So you are—in about half the cases your department is removing children from families solely because they don't have enough money?

Mr. DIGRE. Not solely. People get into a whole complex of problems.

Mr. HERGER. That was the reason you mentioned, about 50 percent——

Mr. DIGRE. That seems to be the trigger. People lose their housing. They end up living on the street to support themselves. They get arrested. They get attracted to the drug culture. There is a whole host of things that develop.

Mr. HERGER. Remember what my question was. Your statement is these people don't have enough money, therefore they are losing their children. Evidently, it is your department's practice to remove children from families in about 50 percent of the cases because they don't have enough money.

Mr. DIGRE. What our juvenile court law is—the definition of neglect is children who are deprived of food, clothing, shelter, medical care, and the other essentials of life. So yes, if families are des-

titute and cannot provide food, clothing, and shelter under the juvenile court law, those children will enter the child welfare system for neglect.

Mr. HERGER. And that is about again, I don't want to belabor it, about 50 percent in the Los Angeles area.

Mr. Murphy, if I could return to some questioning from Mr. Matsui. It almost sounded like you were saying—I want you to clarify it, is it because of policies that we have at the Federal level that are leading to the fact that you have had such a dramatic increase in lawyers that you have needed in instances where—we even have a mother, I believe you mentioned, who was eating glass and yet the system chose to have these children still in her family, under her care? Does part of that come because of incentives or dollars that are coming from the Federal Government?

Mr. MURPHY. No. That answers the question. I think that the system has grown so much with people coming into it that what was perceived a few—and I think there has been so many problems within the child welfare system of kids being harmed within it that we on a local level felt there was a need for lawyers acting as advocates to fight the system. Most of our lawsuits are against the State of Illinois even though we are a government agency. So that is why it has grown.

My frustration is that as I tried to articulate in a not very good basis is that you reach a point where you understand that no matter how many hours you work, no matter how many cases you win, that because of this growth of the underclass, of basically children having children without any—without any chance of—having any chance in life that it is going to go on and on. By the way, I am not against family preservation programs. I am just against the way they were conducted.

Mr. HERGER. Being conducted in a manner where a mother can eat glass, as you mentioned, and still the recommendation of the agency is they stay in the family. You would tend to think that that is not a proper policy.

Mr. MURPHY. We take the most extreme cases. My own lawyers and I was at fault in that case, too, as I told Mr. Matsui, and that is an extreme case.

I will give you a less extreme case where a—a case came in with an undernourished kid at 6 months, went into the hospital, the doctors didn't want to send the kid back home because the woman had an IQ of a 6 year old. And the State of Illinois said we have family preservation in the home, we have a housekeeper there.

I looked at the report, it said the woman had—living at the house was a mess. There were cockroaches all over the place, rodents and garbage up to the ceiling, and also living in there were dogs, cats, a guinea pig, and a monkey. You say to yourself a monkey? Well, maybe that was the smartest person in the house. Maybe smarter than the socialworker who let this go on. That is the extreme you can go to.

The University of Chicago conducted a 5-year study, said it didn't work. It didn't harm, it didn't help. Families should be preserved if there is a family to preserve. It is cheaper and better for the kid, no doubt.

Mr. HERGER. Let me conclude, I do have to agree with both you and Mr. Horn that a system that can allow a situation you just described, also a system that spent approaching $5 trillion over the last four or five decades and has the type of results that we are having now definitely needs to be turned around, and I commend both of you in your attempt and this committee is hoping to change that. Thank you.

Chairman JOHNSON. Thank you, Mr. Levin.

Mr. McDermott.

Mr. MCDERMOTT. Thank you, Madam Chairperson.

I want to set a little context here. The two States that are held up as examples as the way we ought to reform welfare are Wisconsin and Michigan. They cut their welfare costs recently by dropping their grant in one State from $544 to $517 a month for a family. In another State, it was $525, now down to $459. Louisiana, for a family of three, welfare is $190 a month and in the State of Mississippi, welfare is $120 a month. Now, being an Irishman from Chicago, I appreciate the subtlety with which Chicagoans deal with issues.

I would like to deal with some of the rest of you here and talk about this business about children born to children. I have been a witness, an expert witness in dozens of cases as a child psychiatrist on where the kids should be placed, so I have some experience on the street. If a young woman comes in and she has had a child, she is 15 years old and we pass a law in the Congress that says if she is 15 years old, she goes back to school. If she doesn't go back to school, she doesn't get any welfare money and if she does not go back to school or she doesn't stay in school—the Chicago schools, as I know them, or some of the big city schools in this country, are not exactly conducive, we take the kid away from her at that point.

Well, let's—first, we could put her with the family, right? We could let the child be adopted by her mother. Now, very likely this is a family where there might have been some history of the same sort of thing happening. But then what do we do? Do we take the child out of the home? If the girl won't go to school and won't seek to better herself what is the next step? How do we know? Because the argument in the court, in most cases when I was in court, I was in on behalf of the mother because the State didn't provide any services to these very inadequate mothers and so to then say she is an inadequate mother when the State is taking the kid away and say you are not a good mother while doing nothing to help her, it seems like a self-fulfilling prophecy.

What I want to know is what you would outline. When should the State step in and say, OK, young lady, you have not done right by your child and we are going to take that child away from you and put it into an independent—I hate to use the word "orphanage," but some sort of setting. I mean, how would you set the system up to break that cycle that we are talking about?

No, I don't want Mr. Murphy from Chicago. I want to hear from these three. They have been quiet.

Ms. BALASCO-BARR. The first thing that we would do is see if the girl's parent is able to provide a home for both her and her new child. And oftentimes——

Mr. MCDERMOTT. Even if it is a welfare mother?

Ms. BALASCO-BARR. Even if it is a welfare mother.

Mr. MCDERMOTT. OK.

Ms. BALASCO-BARR. That doesn't preclude you from being able to care for your children.

Mr. MCDERMOTT. She would no longer get the grant. You would increase the grant of the grandmother?

Ms. BALASCO-BARR. The grandmother would become the grantee for her grandchild, essentially. Oftentimes, we find that these are problematic families and some States have been able to put together programs where the adolescent and her baby are placed in what we call "group homes" where the foster parent or the group home staff model for her how you are supposed to care for that child and begin to do two things: Reparent the girl who has had the baby and also model for her what is appropriate child-rearing practice, and at the same time she is going to school and getting an education that will lead to self-sufficiency.

But again, this is one of the rules that we have gotten a waiver on in that in order to place a child with foster care, there has to be a ward of the court. But waivers have been given so that the—that is a unit. The young girl and her baby are a unit in foster care and we are able to provide those visits at that time. There are some real good programs around the country, Lewell Belle Stuart in Detroit that has done a good job with taking young girls and their babies and turning them into self-sufficient young adults.

Mr. MCDERMOTT. What is it that prevents those real good programs from being massively applied across the country? Because there are always these demonstration projects, as you say, that work very well. And you say to yourself, every State can see what they are doing in Detroit; why don't they do that everywhere?

Ms. BALASCO-BARR. I think it is because it is—you get so focused on doing it that you don't get out and tell everybody about it. And you consistently take care of the children that come under your supervision in your locality. I don't think there is anything unique or different about somebody having common sense and saying you put the two together so that you don't repeat the mistakes in the future. And at the same time, you have that ongoing—and it is sort of appropriate because we have the Right to Life people protesting today, but the responsibility of what is good sexual responsible behavior is also a part of what is taught to these young girls when they are with us in these group homes and in these special family programs.

Mr. MCDERMOTT. But people in Chicago are desperate. Their numbers are going up astronomically. Why don't they look over to Detroit and see that program in Detroit and say, why don't we try that here in Chicago? What is it—they are certainly looking for solutions, don't you think?

Ms. BALASCO-BARR. I am going to respond because I used to be a children's protective services worker.

Mr. MCDERMOTT. Yes.

Ms. BALASCO-BARR. You get so overwhelmed by the problem you don't see the solution. And one of the things that I believe has helped New Jersey work well, Michigan work well, Wisconsin, Oregon, et cetera, is the quality of the supervision. It is the quality of the training. It is the requirement of the monitoring under Pub-

lic Law 96–272 that keeps the system honest. And I am being very careful talking about Michigan and New Jersey because that is where I work. But it is—it isn't a philosophy. It is a worker's sole belief in family preservation and making good decisions in the best interest of children. And you can't legislate that. It is a feeling. It is in your heart or it is not. And some of us don't need to be in child welfare because we get so hooked on the examples that we have been given from Chicago where somebody wasn't thinking, somebody only looked at family preservation and not what is in the best interest of a child.

The magic of family preservation is training, is supervision, it is review. It is not money. It is not oversight. It is a belief in a direction that this is good practice for children and families. Michigan does not write off substance-abusing mothers.

Mr. MCDERMOTT. You must be a little worried watching us try to write rules to tinker with the system that imply that we know how to legislate from up here what ought to happen out there.

Ms. BALASCO-BARR. No. What we look for from Congress is direction and intent. We count on the administration and the executive branch to give us the rules that we have to go by. And then we get down to case practice and go back to them and say I know what your intent was but this is what actually works.

Mr. MCDERMOTT. Tell me about Los Angeles County. What would you do with the case I outlined, 15 year old, won't go to school?

Mr. DIGRE. OK, specifically, if the 15 year old is not in any way abusing or neglecting her infant, we wouldn't do anything. You know, she would simply, if she was on the public assistance system, would simply be a participant in it. If the child becomes abused or neglected, then it would really depend on the nature of the abuse and neglect and really our judgment about what her capacity is to make changes and to be able to safely take care of the baby. And the alternatives have been pretty well outlined here. In many cases like this, through education, through support, with helping them get back in school, helping them prepare for employment, helping them to stabilize their life through family preservation, she can simply raise her own baby.

Many, many—in many cases, we see that the family structure is so chaotic that probably half of the kids end up growing up with an aunt or a grandmother. That is half of what all foster care is in this day and age. So they are often kept in the kinship system with an aunt who has a more stable lifestyle or with the grandmother who has really got some strength and is ready to do it.

If you do have to remove them entirely from their family network, there are basically two choices and you have to make a judgment about this young woman's potential to grow up and be able to nurture the baby. We have several opportunities where mothers and babies can live together in the same place but in a very structured and protective environment so she can complete her education, so she can make sure that the baby is well cared for and that the baby is protected while she grows up. In other cases, the young woman is so unstable that she just has to be separated from the baby. We will work with her from 1 year to 18 months to try to change that so the baby can live with her. If we can't, we are

going to go into court, terminate her parental rights, and get the baby a new mother and father.

Mr. MCDERMOTT. Do you have a particular system that says at 18 months any case that has been out there comes up and if they are not making it, that is it, you go to court?

Mr. DIGRE. Built right into your Federal law are requirements for a 6-month judicial review and 18-month——

Mr. MCDERMOTT. Probation hearing.

Mr. DIGRE. Absolutely. That is reflected I think in every juvenile court statute in the country. Ours has two cutoff points. Our first cutoff is you start to make the judgment regarding do we need to give up on this person and find a new home at 12 months, and often the judges will continue that to 18 months to give the parents a chance, a second chance. But the 18-month timeline, although there are some exceptions, is pretty firm. If you don't have your act together, if you haven't stabilized your life, you are not able to safely raise your child, about 1,100 or 1,200 times a year we do terminate parental rights and free kids to be adopted.

Mr. MCDERMOTT. You are nodding, Ms. Barr. Do you agree with that?

Ms. BALASCO-BARR. We are going for that. New Jersey has a unique system called voluntary placement agreement and the court is not involved. Unfortunately, we have had some cases that have languished awhile because of these informal placement agreements. But we are rapidly coming into compliance so that we can move more quickly toward permanence.

Mr. MCDERMOTT. Thank you, Madam Chairman. Thank you both for your testimony.

Chairman JOHNSON. May I just clarify, Ms. Barr, something you said earlier in response to Mr. McDermott. You mentioned that you had a waiver. Did you have to get a waiver for the group home program?

Ms. BALASCO-BARR. No. You have to have an allegation of abuse or neglect in order to place a child in foster care. And we are—when you put the mother and the child together, you are not alleging necessarily that somebody has been abused or neglected but this is in the best interest for the kid. So you have to have the waiver in order to access the funding.

Chairman JOHNSON. So this is a Federal waiver?

Ms. BALASCO-BARR. Yes.

Chairman JOHNSON. OK. I wanted to bring that out. I wasn't sure that is what you were saying. But, clearly, if that is what you are saying, that is a perfect example of a need for greater flexibility, even though, in addition, Mr. McDermott's line of questioning and your comments about the judicial review do indicate the combination of oversight and flexible service patterns that we have to try to achieve if we want to improve the system.

I turn to Mr. Johnson.

Mr. JOHNSON OF TEXAS. Thank you, Madam Chairman.

Chairman JOHNSON. Excuse me, Mr. Zimmer. I am sorry. I misread my own list here. It is Mr. Zimmer's chance to inquire.

Mr. JOHNSON OF TEXAS. Sure.

Mr. ZIMMER. Thank you. Unlike Mr. McDermott, I am not an Irishman from Chicago, so I don't know what Mr. Murphy would have said in the last round. I would like to give him some time.

Mr. MURPHY. The Irish are known for fighting amongst themselves, probably more than any other ethnic group. Probably——

Mr. MCDERMOTT. They have never said anything good about each other.

Mr. MURPHY. I think the McDermotts were the ones who were always turning in the Murphys back in—in any event, I think my answer wouldn't be that much different than Peter Digre's here, and that is that a 15-year-old kid who has a child, I don't—I think should go to school if she wants AFDC. And if she doesn't go to school, I would not give it to her. I would go one step further. I don't think I would give AFDC to anyone under 17 unless they have a high school diploma under any circumstances, and I would expect the family to step in and fill the gap, and if the family didn't, that is when the State would step in.

The reason I say this, it sounds very harsh and it is harsh, but I think we have to get the same message across to the underclass that I get across to my own children and you to your kids, and I think we patronize the poor today, whether it is an African-American population, in cities like Chicago it is a racist message. The message is we do not expect anything of you. I think the message has to be we expect the same thing of you as we do of the kid from the north shore in Chicago or from Connecticut or wherever. And that message is a tough message. But the whole message has been soft. The message to date has been anything else but that, act irresponsible, you are going to get rewarded. Act irresponsibly, we will reward you. We have got to turn it around. It will be hard for the first few years but we have got to do it. So I would do it.

I want to make one other comment. Mr. McDermott said Chicago may have bad problems, et cetera. We have an organized group of lawyers in Chicago, myself included. I am the one that went to the press in the case that Mr. Matsui talked about, and I stood up and I said, I made a mistake in that case. That case never would have come out unless there were lawyers doing it.

New York, for instance, has an organized group of lawyers representing children but they have draconian laws of confidentiality which we don't have in Illinois. Most States, the bureaucrats, the child welfare crowd hides behind laws of confidentiality, so they can stand up here and say anything they want to you.

What really goes on, if someone tries to come out and say there is a problem in the system, then everyone says we are going to sue you. I have had half a dozen—not half a dozen—I have had three or four beefs against me with the attorney registration of the disciplinary commission, from State bureaucrats and other so-called advocacy groups because I have gone to the media. This system has more confidentiality than the CIA and the FBI have. That is because it is in the child's best interest, everyone argues.

It is not. And I used to think it was because it was in the bureaucrats' best interest for you guys not to know what really goes on. But now I think the reason, the real reason we have laws of confidentiality is everyone inside the system knows how flaky the

system is but really thinks it is good flakiness and doesn't want the public to know so we hide behind them. The best thing you can do is do away with the laws of confidentiality so everyone can see how bad the system is.

Mr. ZIMMER. Mr. Murphy, I am glad you brought your son here. He should be proud of his father. You are setting an example——

Mr. MURPHY. He is a very bored little boy right now.

Mr. ZIMMER. Well, I can see that. Someday maybe he will appreciate what a candid and forceful and passionate father he has got. And I want to tell you in my experience in my 4 years in Congress, you are the first public official who has ever taken responsibility for a screw up in his department or under his authority, and I want to commend you for that.

Mr. MURPHY. That is because I have only had one.

Mr. ZIMMER. Ms. Balasco-Barr, I want to commend you for the good job you are doing in one of the most challenging divisions in the State of New Jersey. I know how difficult that job has been to manage in years past. I am sorry you didn't get to go through your entire written testimony. I want to give you an opportunity to go into some detail about where you think the Federal program should be changed and exactly how we could focus on outcomes rather than procedure.

Ms. BALASCO-BARR. I believe that each of the 50 States is dramatically different and has different needs, which means that when you have an intent that is promulgated by Congress, there has to be flexibility in allowing that State to develop its child welfare plan according to the needs of that State.

The reason that we are having this hue and cry over family preservation, and it doesn't work, you know, and it does and it is all wrong and it is all right, is because each community and each State has different kinds of problems that are addressed differently. And the—the flexibility that is required is not so much the flexibility in the money but it is the flexibility in the planning.

What Congress and what the administration needs to require from States is an assurance of care, an assurance of the quality of care, an assurance that the money is being directed not into the ways in which have been sort of hinted at about people making money on child welfare, but that money flows to the lowest possible group of folks who can adequately ensure care for kids.

When we—the case plan—and I think it was Secretary Bane who said the case plan is the foundation of child welfare practice. She may not have said it like that. But if you don't have a plan, what are you doing? And that is where the structure of what we do in child welfare has to be, on the frontline worker, the training, the support, the knowing what it is that you are about the business of doing in child welfare.

Oversight doesn't do—I was getting ready to say a strange word, but—it doesn't count for nothing. It doesn't count for nothing if the training, the caseworker, the intent, the knowing what it is that the people of this country want for children and families. If we don't know that at the line level, then we are wasting a whole lot of money and putting in bureaucracy that overview, overview, overview and review. If you don't have any foot soldiers, what are you overviewing and reviewing?

And that is where the emphasis, I strongly believe, in child welfare has to be—the support, the nurturance, the caring for, the training of the child welfare workers and firstline supervisors.

It is—yes, there is a system that we call child welfare and it has advocates, it has people, it has agencies, it has whole lots of folks, but we are all supposed to be about the business of the children and families. And I think a lot of the anxiety and the discussion and the confrontation goes on because sometimes we forget to ask the people that we are supposed to be serving how can we best serve you, and we all get together in conferences and workshops and talk about those people and we haven't taken the time to ask. And maybe we could cut out some of the money if we would use a lot more common sense, a lot more good practice, and we ask the people who we are serving and we ask the caseworkers, how can we help you do a better job? It is not going to conferences.

Mr. ZIMMER. Thank you.

Chairman JOHNSON. Thank you very much. Mr. Johnson.

Mr. JOHNSON OF TEXAS. You really sure this time?

Chairman JOHNSON. Sorry about that. The angle is bad.

Mr. JOHNSON OF TEXAS. Ms. Barr, I like what you say. It seems to me you are saying that we ought to be looking after the children's welfare and not talking about welfare for children. And in so doing, you made the statement that 427 reviews are a large part of your effort in your State.

Do you know how many people are involved? I know you quoted a number, 2-plus million, nearly 3 million.

Ms. BALASCO-BARR. There are 14 staff that directly report to me who do the case reviews. But within each office, there are also case practice reviewers on top of the case review boards that come out of the judiciary system and then the judiciary review by the judges after that.

Mr. JOHNSON OF TEXAS. So you have hundreds, at least, of people that are not really directly involved with taking care of the child but involved in making sure they dot the i's and cross the t's, is that true?

Ms. BALASCO-BARR. I wouldn't try to belittle it to the i's, you know, cross the t's, but we do have a degree of oversight, that I question its effectiveness. If you have established a pattern of doing what follows the law and your outcomes give you that, then there should be relief, some relief from the oversight.

Mr. JOHNSON OF TEXAS. And I also like what you say about no two States are alike. And you know, I don't think we here in Washington can decide what is good for New Jersey and that it is certainly not the same thing for North Dakota or Texas, for that matter, or California, or Chicago, even. And I don't remember making but one mistake in my lifetime, either, Mr. Murphy. I appreciate your comment. That is all I have. Thank you, Madam Chairman.

Chairman JOHNSON. Thank you, Mr. Johnson. Mr. Gibbons.

Mr. GIBBONS. Thank you. A brief question.

Chairman JOHNSON. And welcome, Mr. Gibbons. Pleasure to have you.

Mr. GIBBONS. Thank you very much.

I am of the opinion that the child financial support system in the United States is a mess. It certainly is in my State, in Florida.

What impact would having a better child financial support system have upon the problems that we are talking about here?

Mr. HORN. If I could address that a little bit. I think that certainly we could do a lot better job in both establishing paternity and collecting child support. And it certainly is better if you are raising children to have more financial resources.

But even if we were able to wave a magic wand and collect all of the outstanding child support payments, children would still be at-risk. One of the things we know is that when children are raised in households where the father is absent and uninvolved, children are at-risk even in upper-income households. So if what we are talking about here is simply getting child support payments from these men, as opposed to encouraging and supporting their active involvement with their children, their children will still be at-risk for things like child abuse.

So if we are going to talk about child support enforcement, and we should, and if we want to improve that system, and we should, and if we want to ensure that more children have more financial resources through child support payments, and we should, at the same time, we should recognize that fathers contribute far more to their children's welfare than simply child support payments. We must, therefore, be just as aggressive at ensuring that the fathers have the ability to interact with and be involved in their children's lives.

And along those lines if I could go back to a couple questions before, it seems to me that one of the things we should have done for that 14-year-old girl is that when she was 13 have messages permeating her neighborhood that young boys should not impregnate young girls. Frequently lost in the discussion about child welfare reform is any talk about the missing fathers. We need to help men understand that impregnating women before marriage is a form of child abuse because we know that out-of-wedlock childbearing places children at-risk.

One of the things we need to understand is that we have to focus not just on the mother, the single mother, but also upon the absent adult in that picture. That is the father.

Mr. MURPHY. You know, I think I would agree with Mr. Horn. I would go one step further, and that is, for instance, the New York Times last year did a study on all kids under the age of 15 charged with murder in New York City. Of the 25 kids, 21 had no father involved at all, 2 were silent on the issue, only 2 had a father involved. To me, that is the missing thing.

I don't know if—going after them for money becomes irrelevant, because many of them don't have money, but they should be involved with their children. For instance, again in Chicago, we had a 10-year-old kid who slit the throat of an older woman recently and killed her. And everyone was saying this is a horrible thing, he should go to jail. Of course he couldn't go to jail. The question to me was not the child, but where were his parents? Because essentially he had no upbringing.

And I would—I would on a local level go for laws that said if a kid under the age of x—whatever it is, 14 or 15—was brought in on a charge of delinquency, I would bring the parents in and find out what their involvement was. Now, if it was a poor welfare mom

that tried hard and didn't succeed, well, then there is—but if it is a father who was not involved with that guy, he is the guy that should be in the can, not the dopepeddler, because he is the guy who is responsible. I am not suggesting dopepeddlers shouldn't go to prison, but I think it is more important to get word across to fathers that we are going to put you in prison. You don't have to give them any money; what about taking him out to a ball game, just being there once in awhile? And if a father is not doing that, that is a crime. That, as Wade points out, is child abuse.

Chairman JOHNSON. There are requests for a couple of follow on questions. We will go to Mr. McDermott.

Mr. MCDERMOTT. Thank you, Madam Chairman. One of the questions I wanted to ask, because you talked about training, I would like to know what the minimal qualifications are for hiring a minimal—an entry-level worker in the child welfare system in New Jersey and California and Illinois, if you know them.

Ms. BALASCO-BARR. A bachelor's degree in a human service area, meaning education, psychology—preference is given to socialwork. And there is an incentive for a master's degree in socialwork, psychology or counseling.

Mr. MCDERMOTT. Can't get in with a history degree?

Ms. BALASCO-BARR. No.

Mr. MCDERMOTT. OK.

Mr. DIGRE. It is very similar. It is a bachelor's degree and at least 3 years of experience in socialwork and an educational program in a socialwork-related field. About 70 percent of the time, people we hire have master's degrees. Now the one exception to that is, we recruit very hard in the universities to hire fully bilingual employees, so we do have a class where we can hire trainees and put them through a special curriculum and a special entry in our department so that we have always got an adequate number of bilingual employees.

Mr. MCDERMOTT. And the starting salary?

Ms. BALASCO-BARR. I don't know.

Mr. MCDERMOTT. Range?

Ms. BALASCO-BARR. The range, I think it starts around $32,000.

Mr. DIGRE. About the same, $32,000, $33,000.

Mr. MCDERMOTT. Do you think you are representative of the United States in terms of the qualifications to get an entry-level job in a children's welfare system?

Ms. BALASCO-BARR. I think so. There might be some States that have more of a preference or are more specific about the socialwork degree. But generally we sort of clump it under human services, and then—but that is contingent on a real specific training program after hire.

Mr. DIGRE. In my experience, I believe we are considerably higher both in terms of qualifications and pay, and frankly, back to your earlier question, our turnover only runs in the 6 to 10-percent level. I think that is a direct correlation of, if people can make a living doing these jobs, they get invested in them, they stay, you just have better outcomes.

Mr. MCDERMOTT. Before you give a caseload to people, how much training do people have in New Jersey?

Ms. BALASCO-BARR. They have a minimum of 2 weeks' training before they get a caseload. And then there is a period of time in which they simply, like a shadow caseworker, they accompany a professional worker around on her caseload and then slowly are given cases. And then they come back for additional training after they have had a small caseload of around 10.

Mr. MCDERMOTT. And what—what is the average caseload in New Jersey for a caseworker once they are full?

Ms. BALASCO-BARR. It ranges between 25 and 32.

Mr. DIGRE. The training requirement is 8 weeks in our training academy, which incidentally is funded under IV–E administrative costs. We have three training academies at USC, UCLA and Cal State-Long Beach, our three schools of socialwork. And then they go into a 4-month program in training units, where they are gradually phased in.

Mr. MCDERMOTT. So it is really almost 6 months before they get——

Mr. DIGRE. Yes, exactly.

Mr. MCDERMOTT [continuing]. Actually starting to handle families?

Mr. DIGRE. They are starting to handle, but in a special training unit where they are under special supervision, where they are slowly introduced to it.

Ms. BALASCO-BARR. New Jersey has just started working with the Rutgers School of Social Work in a public child welfare training program. So I commend you—I mean, I envy you, really.

Mr. DIGRE. Our training academies were, incidentally, one of the things that caused the IV–E administrative numbers to jump up.

Mr. MCDERMOTT. I raise this issue because I think it is important for the record and the members to know the importance of training and what you start with when somebody comes in.

When I was, in the early eighties, in the State of Washington, we were taking people with history degrees. And they were getting into the department because they had good grades and whatever, and they really had no experience. You take a middle-class kid just out of college and suddenly hand them a caseload of 15 or 20 families from the inner city, most of them are sinking at sea, so deep that they don't know where they are for a long time. So that is why I think it is important that people recognize the importance of the programs that you are involved with.

Thank you very much, Madam Chair.

Chairman JOHNSON. I thank the panel.

Oh, Mr. Matsui.

Mr. MATSUI. Very briefly, both Mr. Murphy and Mr. Horn answered questions regarding the cutoff of benefits at teen level. Perhaps Mr. Digre and Ms. Barr could give me and the panel their thoughts on the issue of cutting off benefits for teens or whatever group they may be.

In addition to that, perhaps, Mr. Digre, in view of the fact you have worked with family preservation programs, and so has Ms. Barr, very briefly again both of you could answer the question about the example that Mr. Murphy gave where a child was living in a home with pets, monkeys, everything else, with a woman whose IQ was low. And again, I know it depends upon the specific

facts. But what would you do in a situation like that, in terms of your programs?

Chairman JOHNSON. Before the panel answers this question, I want just to clarify that the only proposal that denies benefits to children under 18 does give them Medicaid benefits and food stamps, and requires them to live at home. So those are the dimensions of what we are talking about.

Ms. BALASCO-BARR. Governor Whitman has been asking us for several weeks our reflections, and she hasn't really come to a conclusion, but I do know of her intense involvement and interest in early intervention and prevention. And I think whatever New Jersey does, it will be a decision based on an individual case basis. It will be something that—a decision made in the best interests of children. It will not be a blanket or arbitrary denial of benefits if, in turn, it does far more damage to a child than a principle regarding if you are such and such an age and you haven't done this or that.

Mr. DIGRE. Well, if somebody is terminated from assistance and they are able to go into employment or income through a decent child support check, or be part of a broader family, and if they are able to have employment—the most important thing there is to have health insurance so you can take care of your children and all the health needs of young children—I think it would be fine.

If they end up in a situation where they don't have assistance to get the necessities of life, the juvenile court statutes will be there. And as soon as you hit the point of lack of food, clothing, shelter, the children will end up in the family preservation or foster care system.

In terms of the kind of approach we bring to family preservation, we have taken a comprehensive—packaging 23 services into 1 package, a community-based approach working with community-based agencies, everything from churches to local school districts to the boys and girls club, to mental health centers, people that really have roots in community networks.

We have required a high level of intensity. You have to visit the family as often as 16 times a month to make sure that the first priority of family preservation, child safety, is that the kids are kept safe; and we also institute 17 additional standards of child safety to make sure we are really constantly keeping an eye on the safety of the children.

So it is basically a comprehensive, community-based and very intensive approach, very intensive on the visitations.

Mr. MATSUI. Did you have a—did you want to respond? Maybe you already have responded to the family preservation issue.

Ms. BALASCO-BARR. You know, as we were leaving the table, I did have a thought, an impression, that no one that I know of—and I have been a worker and a supervisor, et cetera—voluntarily wants to say that they are abusing and neglecting their kids solely to get the benefits of family preservation. I don't believe anybody in any community, whether it is rural or inner city or suburban, wants to be labeled abusive or neglectful because of alleged services that are given, or the $300 in emergency money in the family preservation program.

The families that I have met and worked with see only the benefits of having their family strengthened by being involved in family preservation. They then become advocates for the program when they go back into their own communities, when they are in their churches, that oftentimes we are able to intervene in another family that is in crisis before they have been labeled abusive or neglectful because of the kind of value that communities have placed on the family preservation program.

I feel badly that there are some States, and in Chicago it doesn't appear to be working, but I would ask that the committee look at the places where it does work, that you do have people who don't want it to work for whatever reason. But family—for every time they tell you, yes; after 12 months there was another incident, but rather for 12 months there wasn't an incident of abuse or neglect; and then for every family that requires foster home placement and we go through reunification, we have decreased the length of time that that child has been in foster care. And that is a value that we hold.

There are no blacks and whites, and there are no this ways or that ways. All of it has to be in light of, are we really doing the best thing for kids and families?

Mr. MATSUI. I would like to thank both of you and all of you.

Chairman JOHNSON. I would like to thank the panel as well, but before I do, I want to ask one concluding question and make a comment that feeds into the conversation of the preceding 15 or 20 minutes.

Mr. Horn, in your testimony, in talking about what has caused the explosion in the caseload, you say that abuse is up to 40 times more likely to occur when the biological father is not living in the home. Then you go on from that statement to say that this should have driven a change in welfare services or affected the service network in some way and that, instead, it resulted in an enormous effort to maximize reimbursements under title IV–E, which is the administrative costs section of the program, which also is loosely allowed to fund prevention. In other words, you couldn't just address this problem of fathers; you had to go through the burden of administrative costs and all the documentation.

We all know that is a very heavy, complex program, that administrative costs section, and yet that was the only place you could go for money to address this kind of new need. Is that the right conclusion to draw from those two paragraphs of your testimony?

Mr. HORN. There is a wonderful moment in the movie "All the President's Men," in which Deep Throat says, "Follow the money"; and I think if you follow the money when it comes to child welfare, and you understand where the incentives are and where you can draw down large sums of money, you understand where it is that people have put their efforts. And where they have put a lot of effort is in maximizing claims under the title IV–E administrative costs program, because that is where the money is, that is where the incentives are.

And last year, Congress passed and appropriated money for family preservation services despite the fact that there really is no empirical evidence that it is helpful. As Mr. Murphy says, the largest study of its kind shows that family preservation doesn't hurt,

doesn't help, just has a neutral effect. And yet now we are setting up a whole network of family preservation services.

What we have to do is stop telling child welfare agencies to follow the money, but rather to do what makes sense for them, consistent with the needs of their local communities. And if in that community one of those needs is to address the issue of fatherlessness, well, they should be able to do that with the money that they have available to them through Federal funding streams. And so what I recommend and what I continue to urge this committee to consider is making those funding streams much more flexible so that States can use them, given the wisdom that we hear at this table about what is good practice, and stop them from simply following the money.

Chairman JOHNSON. Thank you. And in conclusion, let me say to the witnesses, any suggestions you have for the governance language of a child welfare services block grant or for the means of accountability, we are interested in those two things. Because if we bring moneys together in a block grant, we certainly will not do it without clarifying what the uses of those moneys should be for, nor suggesting how we will know whether it got done or not.

As to the issue of the eligibility for children under 18, that is certainly a part of the welfare debate that is going on before the Human Resources Subcommittee.

I thank you, Mr. Murphy, for your insight into that problem, and all of you, for your thoughtful testimony, written and oral. Thank you very much.

On the next panel are Marcia Lowry of the American Civil Liberties Union, the Children's Rights Project; Michael Petit, the deputy director of the Child Welfare League of America; Ronald Henry, the Children's Rights Council; Brigitte Berger of Boston University, professor of sociology; Corinne Driver, National Association of Foster Care Reviewers; accompanied by Charles Cooper, Citizen Foster Care Review Board; and Karen Howze, adoptive parent.

We are going to let Karen go first since she does need to get back to work.

Sorry, Karen, that this has gone rather longer than we might have led you to believe it might, these first two panels. But it is important for the committee to have a chance to pursue their questions if we are to make good decisions in the future. So with that apology to you and to the rest of the panel, would you please proceed.

Ms. HOWZE. Sure.

STATEMENT OF KAREN AILEEN HOWZE, ADOPTIVE PARENT, WASHINGTON, D.C.

Ms. HOWZE. My children are products of the foster care system in the District of Columbia. My children receive an adoption subsidy each month, and that amount is equal to the amount that their foster parents received when they were in the care of the District of Columbia.

I adopted Charlene and Karie 10 years ago. I was given very little information about their backgrounds and their parents. I was simply told that the parents were "perennial homeless people," with no known history of drug abuse or alcohol abuse.

I think we all know now that perennial homelessness is a deeper problem than just people wandering the streets. In fact, it over the years became very clear to me that there was, in fact, drug involvement by the mother, though it was not street drugs; it was her need to take psychotropic medications because of her mental illness, and the assumption is that she was indeed taking those medications during her pregnancies.

By the time my children were ready for school, it was obvious that there were some very serious problems that were directly attributable at least to the mother's condition and possibly to the father's, who was diagnosed as schizophrenic.

My children were not nurtured in foster care, which exacerbated the situation. One of the things that they had to contend with was a hypersensitivity to touch, which meant that if you touched them or got close to them it felt as though there was a hot poker being run across their skin.

They have serious difficulties processing language and using it. Karie was nonverbal until the age of 6. At the age of 6, Charlene, who is the oldest, one day said to me that she didn't know what was wrong, but she just felt sad. That was 1986, and since then Karie has learned how to speak; she is now 11. By the time she started first grade, though, she was on the road to autism because of the level of nonservice that she had received in the public school system.

Four years ago, Gloria was placed with us. She is a sibling of the other two girls. She has a different father but the same mother. Gloria was caught up in the District of Columbia's lack of compliance with Federal guidelines and standards and lived in foster care and was reunited with her mentally retarded mother over a 5-year period. In that course of time, she was sexually abused by both her mother and by the foster care provider, who is the same provider who cared for the other two girls when they were in foster care. Learning about Gloria's past helped me also understand Charlene's.

Today Charlene, and I mean today, this afternoon, is why I have to leave at 2 o'clock; she is an inpatient at the Psychiatric Institute of Washington. She has been diagnosed as bipolar, or having manic depressive disorder. This child is 12 years old and it is very difficult for a 12 year old to understand what is happening to her body. The end result is these are my children, but without adoption subsidy, which comes to approximately $440 a month, which is not a lot of money—if I did not have that as a resource plus the medical assistance all in one package where I did not have to run around and try to touch base with all the entitlements, I probably would have had to turn my children back in, despite the love that I have for them.

Four years ago, I left my job as an executive with the Gannett Co.; I had been a founding editor of USA Today. I left that job because I could no longer travel and find adequate care that could meet the needs of my children when I was on the road, regardless of how much I was willing to pay.

Today, I kind of piece together whatever I can do to pay my mortgage and pay transportation and food costs and save enough aside to pay for the constant therapy that the children need.

The one thing that I would like to say to the committee is that this entitlement program, unlike a lot of the other things that are going to be discussed here and in the future, is one that was designed for the children. Many people within the social service arena believe that the parents who are receiving adoption subsidy are money-grabbing people who just want to be paid to care for these children; and of the 50,000, I can probably only imagine maybe 2 who would be in that category.

You lose everything when you suddenly find out 5 years after you have made a commitment to a child that that child is not the child or the children that you thought you were going to have. My children may never be independent. My middle daughter, Karie, will never be able to read or write with facility. She tries very hard, but she is almost functionally retarded. Gloria has the beginnings of multiple personality kind of issues that we have not begun to deal with because it is too soon, it has only been 3 years.

Without the little bit of help and the security of that help, I would probably be among those who would say to social services, please come get them, I cannot care for them to the best that they need to be cared for.

Now, since leaving my job, I now place all of my frustration about this system—and in my attempt to really understand it, because it is extremely complex, as the other panels discussed and I am sure we will hear today. I now represent children who are in foster care as an attorney, similar to Mr. Riley.

Is that his name? Murphy. Some Irish something. They all look alike, right? Similar to Mr. Murphy in Chicago on a different kind of panel approach.

What I would say to you is, I am primarily a children's attorney, though periodically I represent parents. The children on my caseload, my goal is to get them into families. This money helps, because the children I represent are just like my kids.

Children who come into the child welfare system came there because something went wrong, whether it is internal or external, and those things that go wrong don't go away. And somewhere in society there has to be a responsibility to assist in paying for it.

I will tell you in the District of Columbia—not necessarily New Jersey, not necessarily Oregon, but I think Ms. Balasco named only 5 States that seem to be paragons of good socialwork; there are 45 others, and those 45 would take the money out of this program and the foster care assistance programs and use it to hire a socialworker who would only help probably to exacerbate the kind of problems that my children experienced and will continue to experience the rest of their lives.

I thank you. The yellow light is on and I made a vow not to hit the red light. If you have any questions——

[The prepared statement and attachment follow:]

STATEMENT
OF
KAREN AILEEN HOWZE

BEFORE THE
SUBCOMMITTEE ON OVERSIGHT
JANUARY 23, 1995

My name is Karen Aileen Howze, and I am a single adoptive parent of three daughters -- Charlene, Karie, and Gloria. My children receive an adoption subsidy each month that is equal to the amount their foster parents received when they were wards of the District of Columbia.

I adopted Charlene and Karie ten years ago. I was given little information about their parents. I was told the parents are "perennial" homeless people with no known history of drug or alcohol abuse. Little was known about homelessness at the time. And no one told me that both parents were severely mentally ill, and that the mother had been taking psychotropic drugs prescribed for her mental illness -- probably throughout her pregnancies.

By the time the children were ready for school, it was obvious that there were problems that were directly attributable to their parents and their early days in foster care. My children were not nurtured. They had a sensitivity to touch that can only be described as the sensation a burning poker would leave on one's skin. They have difficulties processing language and using it. Charlene taught herself to read in kindergarten, but she couldn't stand in line with the other children without bumping into them and disrupting the all important line process. She never cried. She was depressed. And at age six, as I was putting her to bed, she looked at me and said, "Mommy, I'm sad."

Karie, on the other hand, did not speak. By the time she was to start first grade, she began to present signs of autism. She could not function in crowds, and large spaces made her extremely irritable or withdrawn. She is learning to read, but will never be facile with reading or writing.

Four years ago, Gloria was placed with us. She has the same mother as the other two, but a different father. She experienced abuse during her early life that included molestation by her mother and foster mother. She has serious emotional issues that we are dealing with on a daily basis.

It is clear they have challenges that will be with them for the rest of their lives. But, they are loving, caring children who have a respect for themselves and for others. But all of this does not change the reality of rearing them appropriately.

Today, my oldest daughter Charlene is in a local psychiatric hospital. Last June, at age 13, she was diagnosed as manic

depressive, the illness that plagues her mother. She has a condition that she will be faced with for the rest of her life. She will need counseling and constant monitoring of her medications. She must be taught at this early age how to tell whether the medicines are working before her behavior deteriorates. This is a lot to ask of a 12-year old. And it is a lot to ask of a parent who volunteered to love and care for children who had no one, unaware of the level of problems these children face.

My friends often wonder how I am able to handle these extraordinary stresses of parenting special children. I have had to leave a career as an executive with the Gannett Co. Inc., to care more effectively for my children. At the age of 40, I had to change my profession and cut in half my earning power, go through bankruptcy, and start again -- all for the love of my children.

Without the four hundred and forty dollars I receive each month for each children and the medical insurance that is part of the package, I would not have made it through various periods of the past five years. I might have had to dissolve the adoption despite my love for my children. The combinations of problems that my children have make for a household that is frequently manic and probably would be considered classically dysfunctional. I frequently feel so overwhelmed that I think it might be better for the kids if they were returned to the child welfare system. I receive great peace knowing that I am not the only parent who has these thoughts. And I am grateful that I have had the support of family, friends, and the financial support to meet some of their special needs through the adoption subsidy program.

With the program, I have at least eliminated the first reason that many parents give for returning children to the child welfare system, not enough financial resources to meet their needs. As an adoptive parent with special needs kids who is also now a lawyer to children who are in foster care in the District of Columbia, I know that if local jurisdictions are given the chance to decide where the money will go, the choice will be for social workers or support services to maintain the child welfare system. I know, and you have heard from others, that the financial support earmarked for special needs adopted children saves the system financially in the end by promoting permanency for the children. I ask you to consider the parents' side of this equation: the subsidy program provides the support for the children whose life history or life condition make it clear that love will never be enough.

I am attaching to my testimony some information prepared by the North American Council on Adoptable Children, who assisted me in the preparation of my testimony.

North American Council on Adoptable Children
970 Raymond Avenue, Suite 106, St. Paul, Minnesota 55114-1149 • 612-644-3036 • Fax 612-644-9848

With its enactment of The Adoption Assistance and Child Welfare Act of 1980 (Public Law 96-272) nearly fifteen years ago, the United States Congress began to promote the adoption of special needs children in out-of-home care by providing federal reimbursement for adoption assistance payments made to the families adopting them. Under 96-272, states are required to establish adoption assistance programs that provide monthly maintenance payments, Medicaid coverage, selected social services, and reimbursement for nonrecurring adoption costs to families adopting eligible children.

The North American Council on Adoptable Children (NACAC), through the support of the W.K. Kellogg Foundation, undertook this study to: (a) assess the general effectiveness of adoption assistance programs around the country; (b) construct profiles of children and families receiving assistance, as well as the types and sufficiency of benefits made available to them; (c) analyze the impacts that various systemic policies and practices have on the distribution of these benefits; and (d) highlight dominant trends and areas of major programmatic concern among assistance providers and recipients.

To address the objectives described above, input was solicited from state-level adoption administrators and policymakers, front-line adoption workers, and adoptive families in twenty states, including: Arizona, California, Colorado, the District of Columbia, Illinois, Indiana, Kansas, Louisiana, Massachusetts, Michigan, Minnesota, Mississippi, Montana, New York, North Carolina, Ohio, Pennsylvania, South Carolina, Texas, and Washington. In total, 27 administrators/policymakers (i.e., state adoption supervisors, state legislators, budget analysts, etc.), 140 workers (seven–five public and two private–per state), and 532 families (responsible for finalizing 753 *domestic* adoptive placements through licensed public or private agencies *after 1990*) provided information via telephone interview and/or written survey instrument.

BASIC FINDINGS

In compiling the responses of these stakeholders, it was revealed that:

1. ***Adoption assistance programs (AAP) are critical in promoting permanency for special needs children.***

While some respondents questioned specific provisions or practices within their state's adoption assistance programs, there was virtually unanimous agreement that payments and services provided through them are critical in finding permanent homes for large numbers of vulnerable children. In general, interviewees confirmed that adoption assistance programs <u>are</u> acomplishing what they were set up to do--that is, facilitating the permanent placement of children who otherwise might remain unadopted.

Respondents repeatedly indicated that benefits provided through adoption assistance agreements are crucial to the long-term "health" of children and families involved. The statements below--the first two from state adoption supervisors, the third from a veteran adoption worker, and the last, most tellingly, from a letter written by an adoptive parent--typify comments made regarding the vital nature of these benefits:

- "There is no doubt that adoption assistance increases the number of special needs adoptions that occur. There are kids out there who simply won't be adopted without assistance. . . . Needless to say, money used for these benefits is money exceedingly well-spent. Adoption assistance is one of the few areas in child welfare where dollars spent actually make a concrete difference in children's lives."

- "Adoption assistance expenditures are absolutely essential. . . . Waiting kids are the neediest children in our entire society. We as policymakers can't pretend to say that we support the 'family unit' if we don't provide assistance to these kids."

- "Adoption assistance is a God-send. I've been a worker for over fifteen years, and there is no comparison between the number and types of adoptions that are completed now and those that were done when I started. So many families have benefited from the program. I can't imagine what would happen to families if they had to do without these benefits."

- "I am the father of twelve children, four born to me and eight adopted. My adopted children all have special needs. Their disabilities range in severity from a daughter who was born missing her right hand to a son who has Hanhart's Syndrome--congenital absence of one leg, both hands, and his lower jaw. Others of my children are physically able but emotionally disturbed.

  I want to tell you about one of my children because I think it is essential that you have some sense of what it is like to parent a special needs child and, more specifically, to give you some insight regarding the critical importance of adoption subsidies to adoptive families.

  Peter (not his real name) is fourteen. He was originally adopted at age three by parents in Los Angeles. After one year of a difficult placement, his adoptive mother burned him with boiling water. He went to the hospital, she went to jail. He never saw her again. He was sexually abused during his recuperation in the hospital. After that he lived in two separate foster homes before joining our family.

  Peter suffers from post traumatic stress syndrome, attention deficit disorder with hyperactivity, and serious learning disabilities. Until he began aggressive chemical treatment by a neuropsychiatrist, his behavior was leading him straight for residential treatment and quite possibly the criminal justice system.

  Life with Peter is agonizing and painful. It can also be satisfying and rewarding. To say that it is a severe test of our parenting skills is an understatement. We never know from day to day or moment to moment whether he will be threatening one of his siblings with a knife, or sitting quietly playing with Legos; on the roof urinating on the first unsuspecting soul to leave the

house, or reading a book on John F. Kennedy (a favorite of his); holding a playmate's head under water, trying to drown him, or neatly organizing his belongings in his room in his peculiar compulsive way; or running away and wandering all over town with God knows whom.

When his medication is effective, and lately--thank goodness-- it is more often than not, he can really focus and attend. On those days or during those hours we can see his potential for achieving a normal life.

The expenses associated with our and Peter's accomplishments have been enormous. The costs of psychiatric care, numerous psychological evaluations, ongoing therapy sessions, special educational placements, and medicines are a measurable drain on our financial resources. More difficult to measure are the emotional costs of our fear, concern, and anxiety. The costs of alienated relationships (neighbors, friends, and relatives) are similarly unmeasurable but equally great. However, I can assure you that all of these expenses have been substantial.

The adoption subsidy we receive for Peter is a tremendous resource which goes a long way in alleviating the financial strain of caring for him and in procuring the professional assistance he needs. It also gives us the resources necessary to provide a foundation for his life and to strengthen our family structure. Most importantly, it allows us the means to continue our commitment to him and to all our children so that they may grow up safely in a permanent and loving home. With adoption assistance, there is hope for Peter's future, and that's really the bottom line.

In addition to affirming the overall effectiveness of adoption assistance as a permanency incentive, most respondents--particularly those at the administrative or policymaking level--were firm in their belief that adoption assistance programs are an efficient outlet for child welfare dollars. As voiced by one state supervisor, "The adoption assistance program is the best 'bargain' in the entire child welfare realm...We're getting more for our dollars here than in any of our other programs for kids." This is not to say that all interviewees were completely satisfied with the workings of their own, or others', programs. As several emphasized, "We must tighten some things up in certain areas...The subsidy program is not a 'cure-all' for all bad fits. It is merely a safety net."

Nevertheless, and despite these caveats, when specifically asked about the "proper" prioritization of adoption assistance programs within the broader child welfare arena, respondents were quick to stress the importance of subsidized adoption. Ensuing discussions generally focused on the comparative merits and/or drawbacks of providing additional (or fewer) resources at the "front" (family reunification and preservation services) and "back" (adoption services) ends of the service delivery spectrum. Participants agreed that allocating sufficient resources at both ends of the spectrum remains critical for children and families, but *none* advocated for reducing adoption assistance funding in order to bolster front-end services. "Don't get me wrong--family preservation services are definitely needed. We might even be 'short-changing' families a little bit in this area right now. But adoption assistance is very important, and it should not be cut in any way. There will always be a group of kids for whom adoption is the most appropriate permanency option who desperately need adoption assistance benefits."

Chairman JOHNSON. Thank you very much.

Are there questions of Mrs. Howze?

Mr. McDermott.

Mr. MCDERMOTT. How much trouble do you have in getting services for your kids?

Ms. HOWZE. Well, that is another issue. What I found in this community and through networking with other parents who have special-needs kids, we are—our needs are further ahead than the helping psychiatrists, psychologists.

So often we are coming to them and saying, I see this, and they can't figure out what it is. We may have a sense of what it is, but it is all touch and go. In fact, a number of people I know personally, the therapists have said to them, why don't you just turn them back in, it is too much probably for you to handle. So there isn't really a network out there for people who come in this—with this I-am-going-to-help attitude, and then find out that there are very serious emotional and physical difficulties with the children that says, oh, we will be a part of your process.

Instead, it is sort of like, well, you volunteered, just go on and unvolunteer. And that is not unusual.

That is not part of the normal child welfare where you go for social services. It is the rest of the community.

So that is a very good question. It is very difficult to find services.

Mr. MCDERMOTT. Well, I was really driving at a more specific point, and that is, you have Medicaid coverage for these children under the special needs program?

Ms. HOWZE. Right. And my agreement also allows—they have changed the way that they are doing it now, but because there were so many uncertainties and because I am a smart person, I asked that they leave some wiggle room. So when I don't—when I first go to Medicaid providers and when they are not working in the best interests of my children, then I will find people in the community who will let me pay after reimbursement from the District of Columbia.

There have been times when the District of Columbia has refused to reimburse. For example, my middle child has no tongue muscle, so her speech is affected by that. She needed braces to reshape her mouth. We still haven't gotten the braces, though she gets lots of speech therapy, because DHS decided that they didn't think that was an appropriate expense.

So it is a dicey situation that parents are in, and you have to pick and choose what is most important. I have had to choose between focusing on my bipolar child because of the seriousness of that and the level of medication, and hold off on the other two in terms of their needs; and I don't think anybody should ever be placed in that situation, regardless of where the children came from.

Mr. MCDERMOTT. Are the costs for your child being in the mental hospital, are those going to be covered under Medicaid?

Ms. HOWZE. Those are covered completely under Medicaid, and that is another very good issue. Because if I—I don't have health insurance because I left my job. But if I did, she would not be able to go in the way she has been able to go in the last 2 years.

Mr. MCDERMOTT. Thank you.

Ms. HOWZE. Now, I would like to say, I will guarantee the U.S. Government and every taxpayer that my daughter will not be walking around the streets lying on a grate somewhere. That is what this is for. It is the preventiveness that keeps us from having major adult problems down the line, and that is what adoptive parents attempt to offer to their children.

Mr. MCDERMOTT. We are grateful for people like you who will do the kinds of things you are doing. Thank you.

Ms. HOWZE. Thank you.

Chairman JOHNSON. As you work with the system, is there any focus on, as there is with people over 65, you know, the costs of keeping people out of nursing homes versus in nursing homes? Is there any support for perhaps more generous services or supplements in addition to Medicaid, recognizing that if you didn't have these kids, they would almost certainly be institutionalized?

Ms. HOWZE. No. Because I think one of the things that has happened, and probably was happening before the passage of the Public Law, is that the State or local jurisdiction is so bound with their budget vagaries. So, for example, the District of Columbia is in a major, major problem right now.

I happen to have a client who is about to be adopted who is CP, G–2, blind, deaf, the whole bit. It has taken 9 months to try to negotiate a rate of payment for the care giver who wants to keep this boy for as long as he lives. That is the kind of playing with people's lives that occurs, that is based on fiscal and not on the needs of the child.

Chairman JOHNSON. Thank you very much. Thank you for your good testimony. Thank you for your contribution to the lives of these children and to the strength of our society.

Ms. HOWZE. Well, any time.

Chairman JOHNSON. Thank you very much.

Marcia Lowry.

STATEMENT OF MARCIA ROBINSON LOWRY, DIRECTOR, CHILDREN'S RIGHTS PROJECT, AMERICAN CIVIL LIBERTIES UNION

Ms. LOWRY. Good afternoon. I am very glad to have the opportunity to talk to you. Coming at the——

Mr. MCDERMOTT. Use the microphone, please.

Ms. LOWRY. Coming at the end of a morning of very interesting testimony makes it hard to kind of restrain myself to what I originally started out to say, because there have been so many interesting and important ideas here. And certainly the first speaker on this—can you hear me?

Mr. MCDERMOTT. Madam Chairman, your remarks will be in the record, so if there are other things you have heard, I hope that you will carry on so it is a real discussion here.

Ms. LOWRY. I am going to do my best. And certainly the last speaker illustrates a very important point, which is there are in fact extraordinary human beings in this country who are willing to give homes to children in serious trouble and willing to stick with them. And many children who have been in our foster care system are very, very damaged by that experience in itself.

The government spends a lot of money to produce children who are very, very fortunate to find a woman like Ms. Howze, who is prepared to take these children in and make a commitment to them.

We were earlier hearing a little bit about children having children, and let me just say I am—I am an attorney. I represent children in class action lawsuits against State and county child welfare agencies for falling below even what I consider to be the fairly broad standards of Federal law. And one young man, who was in foster care from the time he was 13 months old and is now 28 years old, said to me at one point, when he was getting married, and I said, "You know, maybe you ought to think about postponing having children for awhile"; he said, "I never had a family, I want to have my own family, I want to create my own family." But he had been in foster care his whole life, and although he was able to father children, he wasn't able to raise them. And his children are now in foster care as well.

The points that I really want to make today, that I have heard a little less about, are three:

There must be specific Federal standards in whatever Federal legislation governs the provision of money to the States. There are standards now in title IV–E. They are minimal standards. If we really wanted to have good child welfare systems, we would have more specific standards; and we could do that without taking away from the States, flexibility about how they administer child welfare services. But from the standpoint of these children and particularly from the standpoint of someone who has looked at many of these State child welfare systems, it will be a disaster, in my view, for these kids and for the use of government money if we take away what we have already got in terms of standards.

You heard something today about training for workers. You heard about caseloads. You heard about supervision. You didn't hear about quality assurance, but that is a big issue in the States. None of those things are required in the Federal statute now, and I am not here today to ask you to put them in. But what I am saying is, if you are really looking at quality services, those kinds of things are minimal things to do.

What you have now is a requirement for case plans, you have a requirement to move toward permanence. What you have is some very minimal standards with regard to placements. Without telling the States how to run their systems, I can't believe that anyone would say it is possible to provide decent services for children when you have 150 kids on your caseload. You can't do it.

During trial on the lawsuit against the D.C. child welfare system, we heard testimony from workers who said, when we asked them whether they made case plans, they laughed. They said all I am trying to do is get through my day without a child dying on my caseload. Now that was the right choice for the worker, but if we are serious about trying to get permanence for kids, the workers have to have caseloads and training that enables them to do what we want in the Federal statute. But most importantly, we have to have some general standards that are enforceable and about which there is oversight exercised.

And I really emphasize, I am not trying to come out on the other side of the question of whether the States should have flexibility. They should. They should decide what programs work best to get permanence for kids. But they have got to get permanence for kids or we will be back to where we were prior to 1980 when we had Federal funds go to the States under a statute, title IV–A, that basically did not set any standards at all.

Second, I believe that there has to be some Federal oversight. I do not believe that the 427 audits were effective and I don't believe that they did a good job. That doesn't mean that there can't be good, competent Federal oversight that will really tell us what is happening in the States without being incredibly burdensome.

And finally, whatever standards we have in Federal law must be legally enforceable, so that when the Federal oversight falls back, as it unfortunately has over the last 14 years, and when the States are not meeting the Federal standards, the children have some rights to hold the States accountable themselves.

Thank you.

[The prepared statement follows:]

TESTIMONY OF MARCIA ROBINSON LOWRY
AMERICAN CIVIL LIBERTIES UNION

My name is Marcia Robinson Lowry and I am the director of the Children's Rights Project of the American Civil Liberties Union. I'm very grateful for the opportunity to present testimony today to this subcommittee on this important issue.

Ever since the Adoption Assistance and Child Welfare Act (Public Law 96-272) became law in 1980, we have been bringing lawsuits against state and county child welfare systems for violating the minimal standards that are contained in that federal legislation. We represent tens of thousands of abused and neglected children in city and state child welfare systems around the country.

Foster care systems established and funded to serve children are failing, producing only more damaged graduates who will go on to produce new generations of damaged children, who will continue to lead unspeakably tragic lives and who will increasingly tax our public resources.

In 1980, Congress passed good legislation intended to protect children and to ensure that the billions of dollars spent in state child welfare systems was used as the opportunity to help and to protect these children, to intervene in their lives so they could have a decent childhood and the opportunity to grow up into healthy and productive adults.

For the most part, this legislation has been neither monitored nor enforced, and in many instances these huge amounts of federal money have not been used by the states to achieve the goals that Congress intended.

The protections included in this legislation need to be strengthened and enforced, not eliminated. The federal government certainly needs to do a far better job in its oversight of the $3.5 billion dollars in federal funds expended in 1994 for foster care services. It cannot leave these programs unmonitored.

Even with the standards contained in Public Law 96-272, the states have not done a very good job. If Congress eliminates those standards, by providing child welfare funds to the states in a block grant, and if it eliminates federal oversight of federally-funded programs for abused, neglected and dependent children, by eliminating "427 reviews," these children are certain to be damaged even further. The consequences are truly unthinkable.

The issues being considered by this subcommittee today are critically important to the most desperate and vulnerable children in this country:

> The almost 450,000 children in federally-funded foster care, a number which has increased 62% in the last ten years;
>
> The almost 3 million children reported for abuse or neglect in 1992, a 130% increase in the last ten years.

These numbers reflect the heart-wrenching stories of countless children whose care at the hands of their government caretakers has often not met even minimal standards.

> In Milwaukee, 10-year-old Alan talks matter-of-factly of his current foster family being recruited by his aunt distributing flyers in the neighborhood that say, "I'm a little boy. I like soccer. What I really need is a mom and a dad." Alan entered foster care when he was five. His mother abandoned him, and has a history of drug abuse and imprisonment. He has been in five different foster placements, and two unsuccessful returns to his mother, during at least one of which he was abused by his mother's boyfriend. He has been in at least eight different schools. His aunt, who could not care for him herself, advertised for a home for Alan after the child had remained in a temporary shelter for 11 months, and her phone calls to the child welfare agency had not been returned.
>
> In Philadelphia, a mildly retarded child who had been in foster care for his entire nine years, was taken out of the state by his fourth set of foster parents without his worker's knowledge because the worker had not visited the foster family for over a year and didn't know of their plans to move. His whereabouts were discovered in another state, after he arrived at school with observable bruises. Local police found that the foster parents were controlling his behavior by tying him to a tree.

While we must allow the states to have flexibility in designing and administering their child welfare programs, and in deciding how to meet the standards contained in federal law, we simply cannot assume the states will provide adequate protection to children in the absence of enforceable federal standards and some form of federal monitoring and oversight. This is not an issue of trust; it is an issue of verifying whether the states are, indeed, using federal money to meet certain basic and generally accepted standards. We must remember that these children are more voiceless and powerless than any group in our country, and that if Congress takes away the minimal protections provided by federal law, they will have none.

This subcommittee is addressing the questions of whether the federal reviews required by Section 427 of the Adoption Assistance Act have resulted in better services, and whether block granting federal child welfare services and foster care programs will improve services to children. Since state foster care systems remain so damaging, despite the enactment of Public Law 96-272 14 years ago, it may be tempting to simply try something different. Instead, however, I urge you to make good on the promises of that law, and to take steps to ensure, for the first time, that it is actually enforced.

There are three basic points that must be made.

I. CONGRESS MUST CONTINUE TO IMPOSE MINIMAL STANDARDS NOW CONTAINED IN FEDERAL LEGISLATION FOR CHILD PROTECTION AND CHILD WELFARE SERVICES AS A CONDITION OF FEDERAL FUNDING TO THE STATES.

States are entitled to make their own choices about precisely how to care for their abused and neglected children, but the federal government must be a partner in this process if children are to be protected. Congress is both entitled and obligated to impose these minimal standards because it pays a large share of the costs. It is both necessary and appropriate for Congress to set basic standards on how this money should be spent, and on what general public policy goals it wishes to further.

A consensus exists within the child welfare community, including standard-setting organizations, public administrators, and advocates, about minimal child welfare services and practices that should exist within every child welfare program:

- child welfare agencies must protect children they know to be at risk of harm from abuse or neglect: child-welfare agencies must respond promptly to reports of suspected abuse and neglect and must provide services to protect children who are the subjects of such reports from harm;

- child-welfare agencies must try to keep families together so long as the child can remain safely in the home: before removing a child from his or her home, child-welfare agencies must first attempt to provide services to the child and family in an effort to preserve the family, so long as the child can remain safely in the home;

- child-welfare agencies must try to minimize the time children remain in foster care: for those children who do enter government foster-care custody, child-welfare agencies must provide case planning and services that are geared towards allowing children to return home as quickly as possible or, if that is not possible or appropriate, allowing children to be adopted.

- child-welfare agencies must care for children while they remain in foster care: recognizing that most children who enter foster care are already damaged from abuse and neglect and thus often need intensive services, child-welfare agencies must provide services to children in foster care -- including medical services, stable and appropriate placements, educational services, psychological services, and counseling -- that are appropriate to their needs and that will assure that their experience in foster care is a healthy one.

- children are damaged by protracted stays in foster care- while many children need to enter foster care to assure their safety, it is widely recognized that lengthy stays in government custody can be very damaging for them. And in this respect it is essential to understand that for

children time has different dimensions than for adults: a year in the life of a child can be an extraordinarily long time. Indeed, for an infant or toddler, the passage of months without a stable and permanent caretaker can be permanently damaging. It is critical that child-welfare agencies move urgently to restore permanence to the lives of children in foster care.

In fact, these practices are currently mandated by the Adoption Assistance and Child Welfare Act of 1980, which Congress passed in response to concerns about children drifting for years in state foster care systems. Though the statute imposes only minimal substantive obligations on states that choose to receive substantial federal funds to support their foster-care systems, it does require that states provide planning and services to children in an effort to shorten their stay in foster care and to protect children while they remain in foster care.

The current provisions in the Adoption Assistance Act, Title IV-E of the Social Security Act, set basic standards for child welfare services without proscribing how a state should meet those standards.

For example, the law requires that each child have a written case plan that describes the reasons for the child's removal from his/her home and the appropriateness of the child's placement;

each child have a case plan for assuring proper care and the provision of services;

services be directed toward facilitating either the return of the child to his/her parents, or the child's adoption, so that if at all possible, the child be raised in a family and not in government custody;

the child's case plan assures that the child receives proper care for as long as the child remains in foster care;

that the states develop programs to try to keep children out of foster care whenever possible;

that homes or institutions in which children are placed be reasonably in accord with standards recommended by national organizations;

that the status of children in foster care be reviewed periodically in state proceedings to determine their future status.

These standards are neither overly prescriptive, nor are they utopian. Indeed, from the standpoint of protecting children, even more specific standards would be far better. No standards at all, or standards that are unenforceable, would be disastrous.

Nothing in this statute tells the states how to meet the broad standards in the statute, or what kinds of services or programs should be provided to do so. Eliminating these standards by block granting federal funds will deprive children of all protections.

The problem with the statute is not that it imposes burdens on the states or interferes with the provision of effective services, but that it is simply not being followed. But these protections must remain in place, for a number of reasons.

These protections set guidelines for the states which have some influence on state policy. The protections in federal law provide the standards on which federal oversight efforts must be based. And the protections in federal law provide a basis for advocates to hold the states accountable in the most egregious situations.

At the end of the 1970s, Title IV-A of the Social Security Act, which contained virtually no standards or protections for children, governed the provision of federal funds to state child welfare systems. There were at least 500,000 children in custody at that time, and general agreement that foster care

was no more than a custodial system. The legislative history supporting the enactment of Public Law 96-272 clearly expressed Congressional concern about the lack of federal monitoring of the use of federal child welfare funds. In passing the act in 1980, Congress noted that the federal funds provided under Title IV-A had not been used by the states to "move children out of foster care and into more permanent arrangements by reunifying them with their own families when this is feasible, or by placing them in adoptive homes," and that "there were significant weaknesses in program management which had adverse effects on the types of care and services provided to foster children."

Prior to the passage of this federal statute, children in foster care often had no chance at all to ever leave government custody. Adoption was something usually reserved for infants. If it did not take place within the first several months of a child's life, the child was considered unadoptable. A few examples:

> Carlos entered foster care when he was 13 months old. He lived in an institutional nursery for several years, a series of foster homes and institutions. When he expressed grief over his father's death, he was committed to a state mental hospital. When he turned 16, he was imprisoned for an altercation with a child care institution security guard. He is now 28, lives on the street, and has two children in foster care. There was nothing extraordinary about his case and nothing that happened to him violated the legal standards applicable prior to the passage of Public Law 96-272.
>
> Susie, two, and Donnie, three, were discovered in a closet, where their mother had left them because they had misbehaved. Despite their early neglect, they were still in relatively good psychological shape. They spent their next 13 years in foster care, where Donnie listened on the other side of a closed door while Susie was repeatedly sexually abused by one of their temporary foster parents.

After Public Law 96-272 was enacted, there were some limited improvements in state systems. For example, much more serious attention was paid to developing services to families to prevent abuse and neglect, and to avoiding the need for foster care; to getting children adopted; and to moving children from large, expensive custodial institutions into more family-like settings. State agencies, many of which had previously had conducted almost no planning for children once they entered state custody, became aware of the need to develop written case plans for children and, through those plans, became increasingly aware of the need to set goals and determine the steps to accomplish those goals for children. Within the first several years of implementation, the national foster care population dropped to 270,000 children.

However, these advances were short-lived, for several reasons unrelated to the statute itself but at least partly related to its enforcement.

States soon learned that the federal enforcement mechanism provided in the statute, the 427 review as it was developed by the federal Department of Health and Human Services, was not, in fact, a rigorous, thoughtful monitoring mechanism. Very few states failed these reviews -- indeed, advocates quickly learned that any state that failed a federal 427 review had a system in which children's lives were in jeopardy, to say nothing of their emotional well-being. One reason for this might have been that the only sanction provided by the 427 review to process was the denial of federal funding, a draconian sanction to impose on a child welfare system already unable to provide minimally adequate services to children. And then, in 1989, Congress suspended the availability of the federal funding cut-off, providing no sanctions at all for failing a federal 427 review.

It seems very reasonable to conclude that the failure of the federal government to either conduct meaningful reviews or to enforce the requirements of the federal law made it clear to the states that there would be no consequences -- at least at the federal level -- to their failure to comply with the law.

In addition, however, other factors were at work. State systems in need of widespread reform if they were to meet the minimal goals of the federal statute had barely had time to start developing their own approaches when

circumstances changed. The number of reports of suspected abuse and neglect exploded, with a 130% increase from 1984 to present, an explosion related both to greater public awareness and better reporting procedures but also correlated closely with drug abuse, homelessness, and other serious social dislocations that have devastating consequences for children and their families. Second, children began entering foster care at a younger age, staying longer and manifesting increasingly serious problems -- related in part to increased drug abuse by women -- problems that make it that much more challenging to treat these children and find them permanent homes. Finally, there have been substantial reductions in state and local support for social-service systems, reductions that have robbed child-welfare agencies of critically needed staff and service resources.

Given these forces, and the lack of federal effort to ensure implementation and enforcement, it should be no surprise that foster care systems are failing. However, it would be wrong to conclude that the Adoption Assistance Act has contributed to that failure. Rather, these systems are failing despite the statute's protections and despite the considerable federal resources that the statute provides.

A consensus exists in the child advocacy community about the importance of legally enforceable protections for children in foster care. This consensus is based on a number of factors:

- Children in foster care have no say in the political process- Children in foster care can't vote, usually have no way of communicating with anyone (much less with their elected representatives), and don't have fancy lobbyists or influential PAC's. Indeed, our citizens who are in foster care -- abused and neglected children -- are probably the most politically helpless group in our society. Because of this, it is essential that they have guarantees of minimal care and protection that can be legally enforced.

- Foster care systems are cloaked in secrecy that often is used to conceal illegal and unconscionable practices- Every state in the country cloaks its foster care system in secrecy, prohibiting the disclosure of any information about children's experiences in foster care. Though these statutes often were enacted to protect children, they routinely are used by state officials to conceal illegal and unconscionable practices. Given this secrecy, it is essential that there be the type of external oversight of these systems that legally-enforceable protections provide. Indeed, it has only been through litigation that many of the worst foster-care practices have been exposed.

- Children in foster care are in government custody- Every child who is in foster care is in government custody. Our society long has recognized that when the government takes custody of an individual, there must be basic legal protections to assure that that custody is not inappropriate or abusive. Given the serious problems that pervade many state foster care systems, it is particularly important that children in foster care have such legal protections.

In light of these considerations, it is absolutely essential that Congress assure that children in foster care have minimum protections that are legally enforceable. And given the consensus within the child-welfare community, it is clear that those legally enforceable protections should at least include the standards currently contained in federal law, which could be eliminated if foster care funds were block-granted.

It is impossible to say whether child welfare systems now operate in a way that is more harmful to children than the systems that Public Law 96-272 was designed to improve. It is fair to say that many are not meeting even the minimal goals contained in that law. It is also fair to say that we are squandering the opportunity to ensure that the very large amounts of federal and state money spent on child welfare services be used to benefit, rather than harm, our country's poorest and most vulnerable children.

The solution is not to eliminate the minimal protections we have. The solution is to make these protections more effective.

II. THERE MUST BE ADEQUATE FEDERAL REVIEW AND OVERSIGHT TO ENSURE THAT THESE STANDARDS ARE APPLIED.

This subcommittee is concerned with the question of whether the 427 reviews have, thus far, served to improve the lives of children. For the most part, the answer to that question is no. However, that does not mean that another form of federal oversight would not bring about a different answer. Congress was concerned about the lack of federal oversight in 1980; it should be equally concerned today. While we are critical of the Section 427 reviews that have taken place thus far, we very strongly endorse the need for meaningful, effective oversight, which can and should be provided under Section 427 of the statute. That is not to say that section 427 could not be improved. But even as presently enacted, that section 427 provides a basis for adequate monitoring, if the procedures that are developed under the statute -- about which HHS has broad discretion -- are well-planned and meaningful. The procedures that have been utilized in the past were not.

Section 427 of Public Law 96-272 provides that states must meet certain criteria related to the broad goals in the Adoption Assistance Act in order to qualify for additional federal payments. It does not specify how the federal government should make the determination of whether those criteria have been met.

In the past, the Department of Health and Human Services chose to comply with this provision of the law by conducting what this subcommittee is referring to as the "427 reviews." It would be hard to find many people who believe the reviews, as previously conducted by HHS, tell anybody anything about whether states are protecting children, or meeting the broad goal of trying to ensure that children grow up in families -- either their own, or adoptive -- whenever possible.

As originally enacted, section 427 of the Adoption Assistance Act required states to provide minimal services and have certain systems in place in order to receive child-welfare funds under the statute. In an effort to assess whether states were complying with these minimal mandates, the Department developed a process that involved an overview of state systems as well as a review of a very small number of case records of children in the state's foster-care program. Based on this review, the Department would then declare whether the state was or was not complying with the mandates of section 427. Those states that were out of compliance were to be declared ineligible for federal reimbursement for the fiscal year to which the finding of noncompliance applied.

As an initial matter, the review methodology was hopelessly inadequate. For instance, under that methodology, the Department could look at as few as 25 cases, regardless of how many tens of thousands of children were in a state's foster care system, in concluding that the state was complying with the statute. The shortcomings of the methodology were best demonstrated in 1989, when the Department declared that the District of Columbia had passed its 427 review shortly before a federal judge described the DC system as a "travesty" and found the whole system to be operated illegally in violation of the Adoption Assistance Act as well as the federal Constitution and statutory law of the District of Columbia.

Now, in addition to the fact that Congress suspended the funding sanction for states that failed 427 reviews, HHS has also suspended the reviews themselves. It is my understanding that HHS has been working on new procedures to provide more effective and meaningful reviews. Whether this new version of the 427 reviews will indeed, be better, remains to be seen. But it is clear that effective and efficient federal reviews can be designed to determine whether children are being protected and whether the minimal goals of 96-272 are being met.

However, it is absolutely essential that the federal government not shirk from its oversight responsibilities on behalf of children who are in state custody, or at risk of entering custody, and for whose benefit large amounts of federal money have been appropriated. Section 427 imposes no constraints on HHS' development of an effective and meaningful monitoring process, does not dictate either the scope or the extent of the reviews, and provides wide flexibility to develop reviews that are not unduly burdensome but which nevertheless allow the federal government to protect these children.

Congress went a step further in ensuring the potential effectiveness of 427 reviews by its passage of H.R. 5252 in the 103rd Congress. This bill provides for a far more constructive and far less intrusive new review process. Under this new bill, states substantially complying with the broad goals of the federal law will be reviewed less frequently. States which "fail" the new 427 review will have the opportunity to implement their own corrective action plan, with the provision of technical assistance. The bill still makes federal sanctions available, but provides far more opportunity for non-complying states to bring themselves into compliance with the federal standards, without being penalized by the loss of federal funds while trying to do so.

While the "427 reviews" utilized over the last 14 years have not demonstrably improved the lives of children, they were very deeply flawed. That does not in any way eliminate the need for adequate 427 reviews, Congressional oversight and protection for these children. Without impugning the concerns of many at the state level for their state's neglected and abused children, the inescapable fact is that too many states have a demonstrated record of failing to protect the children in their custody.

III. THE STANDARDS SET BY FEDERAL LAW MUST BE LEGALLY ENFORCEABLE.

In the absence of specific, enforceable federal standards, such as currently exist in the federal Adoption Assistance Act, the half-million children in government custody have few rights against their state custodians, if these custodians fail to meet the minimal standards and provide basic protections to them.

Although the states are entitled to discretion to determine the best way to meet the federal standards and to provide proper care for children, what programs are most effective in trying to ensure permanence for children, and how best to provide services to these children. However, the states should not have the flexibility to take millions of dollars in federal funds and not even make efforts to meet these very broad goals, or to operate their child welfare system in such a way that makes the achievement of these goals impossible.

For example, to take some real-life illustrations, state child welfare systems in which the telephone lines set up to receive abuse reports often go unanswered are not making efforts to protect children. States which leave children in unlicensed and unsupervised foster homes are not experimenting with new program designs. States which determine that abandoned three-year-old children are unadoptable -- without trying to recruit adoptive parents for them -- are not trying to find permanent homes for children. States which fail to provide any treatment at all for sexually abused children are not providing services to meet children's needs. Nevertheless, and regrettably, these situations exist in too many of our cities and states -- all of which operate federally-funded children welfare systems.

The standards currently contained in federal law do not permit advocates to challenge a state for violating federal law based on the view that one approach to children's services may be better than another. It does permit advocates to seek protection for children, however, when a state does not even develop its own reasonable approach. Without such standards, and the right to enforce these standards, children are entirely without protection.

Increasingly, and in some measure because the federal government has not itself ensured meaningful implementation of the law, the standards in federal law have been used as the basis for lawsuits on behalf of abused and neglected children. For example:

> In the District of Columbia, Caseloads were so high that one worker testified she couldn't develop plans for children -- she just wanted to make sure that all the children on her caseload were still alive. Almost no children were adopted, because the District did such a poor job of recruitng adoptive parents and making children legally available for adoption. Young children lived for years in expensive emergency institutions because foster parents weren't recruited or screened, and there were virtually no services to either help parents keep their children at home, or to help them take children back from foster care.
>
> In addition to being extraordinarily damaging to children, the Washington, D.C., foster care system wasted extraordinary amounts of

money. Children were kept in the most expensive but unsuitable kinds of care, and left in foster care when they could have been discharged either to their parents or to adoptive parents. The computer system was so outdated that over a million dollars was being paid to foster parents who no longer cared for children but whose names had never been taken off the rolls.

After a successful lawsuit was brought, problems remain but a great deal has already changed: training was instituted for all workers; the number of workers tripled; foster homes are now being visited and supervised; hundreds of children are being adopted; special units have been created to help children stay out of foster care by providing short-term help to their parents; and the response to child abuse and neglect reports has become more timely.

Now, because of continuing difficulties, outside experts have been brought in by the federal court to help the District solve some of its problems that continue to put children at risk.

LaShawn had spent her entire six years in foster care when the case went to trial, and was matched with adoptive parents because of the lawsuit. Her adoptive father said that when she came to live with his family, she didn't even know how to jump rope, tie her shoes, or play with other children. "This was a little girl who didn't know what a hug was. She didn't know what love was," he has said.

Although the problems in the District of Columbia are well known, the problems in its child welfare system are not, unfortunately, unique to this city.

Other systems have had similar problems, and lawsuits there have produced similar results.

In Connecticut, a lawsuit was filed after the state social services commissioner likened the system to a "hospital emergency room" and decried the "senseless, merciless destruction and devastation of our children." The state agency was failing to investigate 60% of the children reported as abused or neglected. The medical needs of children in state custody often did not receive routine medical care, foster parents were so underpaid that committed foster parents had to reach into their own pockets to buy adequate food and clothing for children, limiting the number of people willing to provide homes for children. Connecticut had many of the same problems afflicting the Washington, D.C. system.

A lawsuit filed in 1989 resulted in a consent decree approved 13 months later. Since then the state has been moving forward with implementation, sometimes unevenly, but with the clear goal of improving services for children in the state. Among the many achievements: a 50% reduction in caseload, so workers can provide better services to children; the creation of a training academy; the development of statewide policies; and an increase in payments to foster parents to meet minimal government standards for the care of a child.

In New Mexico, an adoption system was created where none existed, and where one-third of the foster care population was characterized by a state report as being "in limbo," after a lawsuit based on federal law was filed.

In Kansas, a lawsuit based in part on federal law and relying on the results of a state auditing agency that concluded that protective service investigations were not taking place as required by law, that children were not receiving case plans and were being placed in dangerous foster homes, and that few efforts were being made to have children adopted when they could not be returned to their parents, resulted in a consent decree that incorporates a statewide reform plan.

It would have been difficult to have produced these benefits for children without being able to rely on the specific standards contained in federal law, and which Congress is considering eliminating through block granting.

It is an extraordinary fact that for many children in federally-funded state foster care, their time in government custody will be more damaging than the abuse or neglect they suffered originally. It is extraordinary that this is taking place at the expense of the federal taxpayers. For the most part, states have not complied with the existing minimal protections afforded to children in existing federal law. Nor is there any evidence at all to suggest that the existence of the law or of the 427 reviews were in any way responsible for the deplorable state of child welfare services nationally. Eliminating rather than strengthening these protections, and the possibility of effective federal oversight, by block-granting federal child welfare services and foster care programs to the states will surely not provide any benefits to children. It will only leave them more vulnerable and unprotected than they already are.

Chairman JOHNSON. Thank you very much, Ms. Lowry.
Mr. Petit.

STATEMENT OF MICHAEL PETIT, DEPUTY DIRECTOR, CHILD WELFARE LEAGUE OF AMERICA, INC.

Mr. PETIT. Madam Chairman and members of the subcommittee, I am Michael Petit. I am the deputy director at the Child Welfare League of America, a 75-year-old nonprofit organization that represents 800 public and private child-serving organizations. About 2.5 million children a year are served by our member agencies.

In the last 25 years, I have worked on child welfare issues and have traveled to all 50 of the States working to evaluate and strengthen their child welfare systems. In the 8 years prior to that, I was the commissioner of Maine's Department of Human Services, which is that State's child welfare agency. In my travels, I discovered that the good news is, like the lady who testified at the beginning, there are thousands of individuals privately and within agencies who successfully protect children each day and who help families learn to better manage their own affairs. Yet, hundreds of others—hundreds of thousands of other children are living in dangerous and neglectful situations and most of those children are presently known to the authorities. For these children, government at all levels is the one thing that stands between them and grave injury.

It is our strong belief that the Federal role in this instance needs to be strengthened, not weakened. The real issue is that which you were alluding to earlier, which is that an increasing number of families are unable to manage the affairs of their children safely. The consequence of that is a State and county child welfare system that is so overburdened that many children in danger are literally receiving no protection whatsoever.

On the whole, the child welfare programs that we have visited in the country—and as I said, our work is helping those States to evaluate their systems—are generally severely underresourced. There are no States that meet Child Welfare League of America standards. We have been setting those standards for nearly 75 years. We have 11 volumes of such standards.

The caseloads that we encounter are as much as 100 to 1. Our recommended caseload standards in some of those programs are as low as 15 to 1.

With respect to flexibility and block granting, we think that is a terrific idea, at one level, the flexibility. But if the States were operating to the maximum degree of flexibility and efficiency, they would still be severely underresourced. There are simply too many families—States have been virtually overwhelmed by the crush of cases that have been brought to their attention.

The 18 children that you made reference to earlier, Madam Chairman, last year in Chicago, that were discovered in a neglectful situation, I subsequently met with many agencies across the country around that particular issue. It is viewed as a garden-variety type of a neglect problem; it is not viewed as an extraordinary case at all.

Representative McDermott asked what can be done programmatically. Among the things we are strongly advancing are

notions like getting serious with teenage pregnancy and all that means. Home visitor programs to certain households, particularly teenagers on AFDC, until such time as it is proven that home visitations are no longer necessary.

We have got some excellent models on that: Serious parenting instruction; child care in every school in this country, including programs that are run by junior and senior high school students; and with regards to training, one-half of the States have no preservice training right now for the child welfare workers. You can be a 23-year-old socialworker on Friday doing food stamps, and on Monday you are talking about somebody who has had sex with their children.

Having served as a State administrator myself and having interviewed hundreds over the years, 427 is a meaningless process for most of the States. It represents no kind of sanctions to the States whatsoever. It is viewed as a paper tiger.

Overall, I would give the system a grade of D. The reason why is that, for example, half of the kids that are killed in this country at the hands of their family members are already previously reported to the department. In one study, 40 percent of the kids returned from foster care, 1 year later, had been reabused and were back in State custody.

And one area that is seriously neglected is child sexual abuse. It is our belief right now that fewer than 1 out of 10 child sexual abuse cases in this country, where a felony has been committed, result in a prosecution. That means that 90 percent don't have a prosecution. And in State after State we ask judges, socialworkers and others if they believe that there are children that they know who are living at home with a sexual perpetrator, and the answer is always yes.

Some States have a much stronger inclination to do this than others. Let me give you two States, 3 million people in both States. One of them spends $24 million on its entire child welfare system. The other one spends $240 million on its child welfare system. Block granting anything back to the States is not going to change that reality.

The State's general fund appropriation is $4 million in the first instance. In that State, I have visited children in jail, 9 years old, whose only offense is to have been sexually abused by an adult, in jail because there was no other place to locate the child; children, 13 years old, in straitjackets because of mental illness, in local lockups without legal representation.

One of the consequences of all this is that telephone calls come into jurisdictions in which they are supposed to generate a protective investigation. In one jurisdiction we are working with right now, they get 30,000 referrals a year. They screen out 24,000, they go out on 6,000. They don't go out on 24,000. Imagine a comparable situation with the local fire department in which there is an inquiry over the phone trying to screen out a fire call because of, how hot is the smoke and what color is—what color is the flame?

Finally, with regards to the paperwork issue that was raised by Congressman Matsui, our experience, when we asked socialworkers this question—we have asked thousands of them, how much of your time is spent on paperwork versus families, it ranges from a

low of 3 percent with families, to not much more than 25 percent with families.

There is a crushing weight of paper. I would submit, though, that it is marginally related to Federal reviews. It is mostly related to the kinds of legal processes that are going on in the courts.

And I would just note that on that, when we are talking about taking children away from their families, I have a hard time imagining something that isn't going to be largely driven by certain legalistic considerations. Our testimony includes, I think, some 14 recommendations which I would be happy to talk about at some point.

[The prepared statement follows:]

TESTIMONY OF MICHAEL PETIT
CHILD WELFARE LEAGUE OF AMERICA, INC.

Madam Chairwoman and members of the Subcommittee, I am Michael Petit, Deputy Director of the Child Welfare League of America (CWLA). CWLA is a membership organization representing 800 public and voluntary child serving agencies that assist over 2.5 million vulnerable children and families each year. CWLA welcomes this opportunity to testify on federal child welfare programs and how the Congress might better protect children and improve their lives. I believe this is an urgent matter. Children are in danger and the federal government has a key role to play to protect them.

The principal focus of my work throughout my career has been to work on behalf of families in the care, development, safety and protection of children. At CWLA I also serve as the Director of CWLA's National Center for Excellence in Child Welfare. I have been to all 50 states and in nearly all of them have worked with state and local governments to evaluate and strengthen their abilities to better protect our nation's children. In the eight years prior to my work at CWLA, I served as the Commissioner for the State of Maine's Human Services Department. That Department had jurisdiction over child welfare, AFDC, Food Stamps and Medicaid. In the decade prior to that, I worked for private non-profit organizations such as United Way at the neighborhood and local level.

CWLA concurs wholeheartedly with your Subcommittee's desire to reexamine the effectiveness of current federal efforts on behalf of abused and neglected children. The good news is that there are many thousands of individuals, to be found in every state and jurisdiction, who are deeply committed to the care and safety of children and who everyday successfully protect and serve children at risk, whether in or out of their home, and who help families learn better ways to manage their own affairs. Their dedicated efforts provide the front line assistance that children need and these workers deserve great recognition for the important work they perform daily.

However, children's lives are in danger and the federal government has a critical role to play to keep them safe. I have found that, despite the best efforts of local communities and state governments, the work of the country's public and private child welfare agencies is insufficient to the task. Unless the federal government provides more leadership, not less, promotes greater accountability, not less, and commits more resources, not less, to the care and protection of children, states will not be able to adequately protect and care for the lives of our children. Hundred of thousands of children are at risk of serious injury and death and many of them known to authorities are failing to receive the attention and protection they require.

Much needs to be done to remedy these terrible situations. Specific to the questions posed by the Subcommittee, CWLA urges that an entitlement be maintained to help children receive the services they need to keep them safe. A block grant could severely undermine state and local community efforts to protect and serve children by eliminating the individual guarantee of support. Many of these children are in state custody. In other words, the state is their legal parent. They should not have to depend on an accident of geography and goodwill to be protected. We also must ensure enforceable protections for children in whatever systems are put in place. Accountability that includes a range of sanctions with real teeth is needed at all levels. Right now, 427 reviews don't accomplish that objective.

While child welfare is the administrative focus on these issues, the courts, as we all know, play a central part in child welfare determinations and must be included in new partnership to address the problems.

STATE CHILD WELFARE SYSTEMS ARE SO OVERBURDENED THAT MANY CHILDREN IN DANGER RECEIVE NO PROTECTION

I have worked with thousands of individuals engaged in the process of caring and protecting our nation's most vulnerable children—social workers, judges, law enforcement officers, prosecutors, state and local administrators, elected officials, therapists, educators, public health officials, and hundreds of children and families whom the system is intended to serve. I have learned first hand of many abused children who are protected, and whose families are successfully helped, because of effective intervention. But I have also learned first hand of numerous children, young and old:

- who are profoundly neglected—no food; no medical care, no personal hygiene
- who are abandoned—a six-year-old boy pushed from his car and left on the interstate
- who are seriously abused—severe head injuries resulting in a life time of paralysis and semi-consciousness spent in nursing homes
- who are raped repeatedly by adults—as young as 4 weeks old with venereal diseases, a 5 year old child with cerebral palsy sexually assaulted in her own crib
- and who are killed—burned to death in furnaces, hacked to death, drowned when forced to drink gallons of water.

Unfortunately, those agencies and individuals with the principal responsibility for addressing the horrible problems experienced by many children are nearly overwhelmed by the sheer number of children in need of protection, and by the increasing number of parents unable to fulfill their traditional protective responsibilities to their children. Having worked in this field for 25 years, I conclude that the nation's response to the often life-threatening conditions in which many of these young victims lives is unorganized, underfunded and, ultimately, completely inadequate.

Although child welfare operations vary wildly from one jurisdiction to another, sometimes even within the same state, and certainly some do a better job than others, the federal Title IV-E 427 review process has largely been ineffective in capturing these differences and certainly in compelling, or even guiding, corrective actions to improve the situation.

FEDERAL PROTECTIONS AND SANCTIONS ARE CRITICAL

Having served as a state administrator myself, and having worked with hundreds of others over the years, I can state with confidence that the use of federal sanctions aimed at correcting major deficiencies in state or local operations is not a worry to the states because, in practice, there are no federal sanctions. While the 427 review process has indeed created an onerous paper burden in some jurisdictions, it has not worked to effectively change the way the system care for our children. Congress and the Administration have begun to take welcomed steps to improve the 427 review process. Much more needs to be done.

The idea of a vigorous federal monitoring role must not be dismissed. In fact, CWLA believes that the federal government must assume a much stronger role in working with state jurisdictions, in a true partnership, to attack the widespread problems of child abuse and neglect which deeply threaten and damage our culture.

PRINCIPLES OF P.L. 96-272 REMAIN SOUND

CWLA continues to endorse the progressive principles passed by Congress in 1980 and contained in the Adoption Assistance and Child Welfare Reform Act (P.L. 96-272). We believe this law's emphasis on making all reasonable efforts to allow abused and neglected children to remain in their own homes with their own families, if it can be done safely, is the proper central tenet in providing assistance to troubled families and their children. In many jurisdictions across the country progress has been made in introducing family-focused, child-centered services in response to abuse and neglect; many children have been able to remain safely at home or safely returned to their homes after receiving short or long-term placements because of P.L. 96-272's commitment to reasonable efforts and family reunification. This is an accomplishment with which we can be pleased.

Specifically built into the law are the following priorities:

- providing supports to families in order to prevent separation of children from their families

- where separation is necessary, providing support services to enable children to be reunited with their families

- where reunification with their own families is not possible or appropriate, providing services that enable children to be adopted or placed in permanent foster homes with some form of legal protection.

To accomplish the above purpose and priorities, the law incorporates a number of procedural reforms and fiscal incentives:

- Provision of preplacement and postplacement services to keep children in their own homes or reunite with their families as soon as possible. These are sometimes referred to as services that must satisfy the "reasonable efforts" clause of the law.

- Requirements of case plans, periodic reviews, management information systems, and other procedures to ensure that children are removed from their homes only when necessary and are placed with permanent families in a timely fashion.

- Redirecting federal funds away from inappropriate foster care placement and toward permanent alternatives, particularly adoption.

- Establishment of adoption assistance programs, specifically federally funded subsidies for adoption of children with special needs, such as older, disabled and minority children.

Despite these provisions, the nation's collective response to abused, neglected and abandoned children is failing to provide both protection and appropriate living arrangements for hundreds of thousands of them: many are removed from their families prematurely without reasonable efforts having been made. Some are not removed quickly enough. Many children unnecessarily remain in foster care because of inadequate reunification efforts. Other children are reunified but without adequate follow-up services to their families, resulting in re-abuse and removal once more. Some children and youth are placed in facilities appropriate to their needs, others are placed in programs that are too restrictive or nor restrictive enough. For some children, known to be living in dangerous or threatening conditions, little or nothing is being done.

It is also reflected in the deaths of children killed at the hands of family members, nearly half of whom had previously been reported as abused or neglected prior to their death. A study found that 40% of one group of foster children, who had been reunified with their families, were placed back in foster care within a year because of re-abuse or further neglect. An informal, but reliable, opinion surveys of child welfare agencies and law enforcement agencies revealed that perhaps fewer than one in ten strongly suspected cases of child sexual abuse result in prosecution and conviction.

FEDERAL GOVERNMENT HAS KEY ROLE

CWLA strongly believes that the principal role of government and private agencies in the lives of troubled children and families is to enable families, whenever possible, to better manage their own affairs and safely care for their children. We are talking about the protection and care of millions of children.

Some jurisdictions have a much stronger inclination and capacity than others to address this urgent challenge. For example, consider the commitment of resources: two like-sized states of nearly 3 million people have allotted hugely different sums to child welfare, twenty-four million dollars in one state, two-hundred and forty million in the other, the last time I looked.

In the first state, we have seen children as young as nine years old, whose only offense was to have been sexually abused by an adult, spending days in jail because there was no foster home, emergency shelter or residential care facility for the child. In the second state, there is a well developed network of treatment services and shelter to help the child.

In the first state, child welfare workers involved in the most intimate aspects of a family's life can begin their job having received little or no training. In the second state, workers must have sufficient experience and education prior to being employed by the agency and receive weeks of specialized training prior to ever handling a case.

In the first state, juveniles who run away from home or who commit the most modest offenses, such as shoplifting or not attending school, can find themselves in a state training school or local jail, sometimes without legal representation, because there is no alternative shelter. In the second state, there is a network of specialized treatment and residential care aimed at meeting the child's needs and getting him reunited with his family as quickly as possible.

In the first state, there are no intensive family preservation services which might have prevented placement in the first instance. In the second state, there is a statewide network of family preservation services preventing hundreds of unnecessary placements each year.

In the first state, a well defined blueprint documenting in detail the extensive child welfare problems that exist, including what it would take to correct the problems is ignored by the governor and legislature despite extensive press coverage and a large state budget surplus. In the second state, the governor and legislature convene public forums, hold press conferences, convene citizen groups and conduct the extensive public education and planning needed to effectively protect abused and neglected children.

Neither the 427 review process nor any other federal oversight mechanism captured the differences in these two states and the subsequent harm that routinely befall the children in the first state.

The different responses by these states are not unusual nationally. In some states, elected officials provide leadership on behalf of abused children. In other states, we regularly encounter situations in which the basic attitude towards child welfare, communicated by top elected officials in the executive and legislative branches to child welfare administrators at budget time, is "don't ask, don't tell." And they usually don't. When they do, they may be fired, a situation we have encountered more than once. Neither the 427 review process, nor any other federal oversight mechanism, is able to address this reality at the present time.

These wide variations have tremendous implications for children. For instance, in some jurisdictions virtually all child abuse and neglect referrals result in an onsite investigation. In one jurisdiction in which we are working 30,000 referrals are made each year to the public child welfare agency. The agency screens out 24,000 by telephone. Imagine a fire department, whose dispatcher receives many false alarms, screening out 80% of its calls by telephone: How hot is the flame, the dispatcher might ask? What color is the smoke? What fabric is burning? Are you able to put it out yourself? This would be absurd, of course, because everyone recognizes that the consequences of being wrong in the assessment are so severe that it is worth the added cost to check every situation in person. This is how it should be for our children.

CWLA believes the amount of child abuse and neglect in this country is a national crisis. We believe it is contributing directly to subsequent criminal behavior. We know that many child victims eventually turn the tables and become the menacing victimizers we have come to fear. In the debate about crime insufficient attention is being paid to the connection between child abuse and neglect and public safety. We absolutely concur that neighborhoods, communities, counties, states, public and private providers of services, families themselves and all others with an interest in the well-being of children must be deeply involved and have important roles to play in solving the alarming and worsening problem of abuse and neglect.

We believe equally however, that despite the best efforts of local communities and state governments, the work of the nation's public and private child welfare agencies will remain insufficient to the task unless the federal government provides more leadership, promotes greater accountability and commits more, not fewer, resources to the care and protection of children. We believe a national strategy is necessary and must be tied together by a federal government working in close cooperation with states and local communities in the public and private sectors.

We recommend:

1. **First, maintain the entitlements** for all services necessary to provide care and protection to children who are brought into state custody. Block granting the entitlements would undermine the ability to protect and serve children and would make safety dependent on accidents of geography or individual goodwill. Careful and thoughtful consolidation of some discretionary activities in related areas would make good programmatic and fiscal sense.

2. **Include enforceable protections** in whatever systems are put in place. At present the federal government is a paper tiger in addressing the worst violations of federal intentions in child welfare. In numerous instances where class action litigation has been filed the state had recently passed a 427 review.

3. **Assume greater responsibility for coordinating and enforcing all federal child welfare initiatives,** and provide support and guidance to the governors enabling them to better coordinate federal efforts at the state level.

4. **Promote a nationwide unifying theme of child-centered, family-focused casework practice** as the heart of government strategy for protecting the safety and best interests of abused and neglected children.

5. **Provide support for the full array of prevention and treatment services** necessary to assist victims of child abuse and neglect.

6. **Develop national standards for child welfare practice** and condition federal funds to the states upon full adherence to these standards by the year 2000.

7. **Develop a national data base,** with mandatory state participation, that allows for more serious and effective accountability and planning.

8. **Establish and enforce more rigorous and comprehensive scrutiny of child welfare outcomes** within the states.

9. **Continue support for new computerized case management technology** that promises to better protect children, reduce unnecessary removal of children from their families, greatly reduce paperwork, increase social worker productivity and strengthen management capacity.

10. **Identify the true costs required to respond effectively to the country's child welfare crisis,** based on uniformly developed, state-by-state budget estimates, and provide the federal funds to support the national governments fair share needs.

11. **Develop a nationwide system of worker recruitment, training and certification,** including ongoing training of all child-serving staff, supervisors and administrators, similar to that which exists for nurses and teachers.

12. **Conduct a nationwide campaign to recruit new foster and adoptive homes and to retain existing homes,** and assist the states in their efforts to retain current foster homes and promote adoptions.

13. **Develop a technical assistance capacity to assist the states** in the transformation of their child welfare systems.

14. **Convene a national panel, to report back to the Congress** by this summer, on the scope of the problem nationally and the applicability of the above recommendation, and others, on this national failure to our children.

We recognize better than anyone that the federal government is unable to provide the warmth and attention that every injured child requires for healing. But we do know more about producing healthy children than ever before. We are committed to the idea that children do best when families are attentive to their needs. We believe equally that families themselves do best when communities are attentive to **their** needs. That speaks to the need for supportive public policies that help communities help families in the care and protection of all children. The federal government must assume a far more vigorous role in working with the states to assure that every child in every community is protected.

Thank you for this opportunity to express our concerns and suggestions. We and our 800 member agencies across the United States look forward to working with members of the Subcommittee and its staff to craft smarter and more effective ways to address the needs of injured children.

Chairman JOHNSON. Thank you very much.
Mr. Henry, Children's Rights Council.

STATEMENT OF RONALD K. HENRY, ESQ., CHILDREN'S RIGHTS COUNCIL

Mr. HENRY. Thank you. My name is Ron Henry. I am a volunteer child welfare attorney, testifying today on behalf of the Children's Rights Council. The Children's Rights Council would like to thank the Chair and the committee members for scheduling this very important hearing on the reform of the Federal role in child welfare programs.

The Children's Rights Council is a nonprofit educational organization whose sole purposes are the encouragement of family formation, family preservation, and the demilitarization of divorce to keep both parents actively involved in the child's life.

In providing services to children, we must always begin with the understanding that the best service we can provide to at-risk children is to reduce the number of children who become at-risk. Regardless of the social pathology that is under study—whether it be teenage pregnancy, drug abuse, suicide, low self-esteem, juvenile delinquency, poor academic performance or any of our other social ills—the greatest causal factor that researchers find for us is family breakdown or family nonformation or, as you heard from some of the earlier witnesses, father absence. We believe and we are here to talk to you today about the most underutilized resource in child welfare; that is, the family itself.

All of our programs currently focus on the single custodial mother alone. We give huge arrays of resources, many of which you have heard described today. We prop up that single mother as a stand-alone entity and insist over and over again, despite experience, that we are going to make it work.

Many of these single-parent families will never be able to function without support. Many of them will never even be able to function with support. Many of them continue in the very abuse and neglect that brought the child into the system in the first place. We know that from our history. That is why we have been discussing such things as orphanages, and other third-party placements for children.

Right now, our problem is that policy assumes a dichotomy of choices for children. Either we preserve that single-mother, propped-up situation, or we go to third-party care. We believe there is another way, a middle ground. That is, kinship care, using the resources of the full connection of blood-related relatives, all the people who care about and have a passionate love for that child because of their relationship to the child. That is the resource that is often overlooked and the one that we think needs to be brought more fully to the center.

If we continue to believe that the single custodial mother is the child's sole family, we will be butting our heads against the wall forever. We will be continuing to come up with new props, new services, 7-days-a-week housekeepers and the rest. That is not going to get us anywhere.

The typical at-risk child enters the welfare system as the result of an abuse and neglect complaint. Many of these abuse and ne-

glect complaints are initiated by other family members who observe and are concerned about the child's status.

Now, before addressing the positive steps that we can take as a government to aid that child, we first must be sure to obey the physician's creed, "do no harm." Too often, our approach does harm. When the Federal Government's narrow definition of family preservation is heavily oriented toward defending the single-parent custodial household, Federal intervention can and does actually prevent an improvement in the child's situation.

Take, for example, the sadly all-too-common case of an abusive or neglectful parent who is reported to authorities by other relatives, such as the grandparents. The grandparents are concerned about the welfare of the grandchild. They are frequently willing, even eager, to provide rescue for the child in their own home. Rather than obeying the physician's creed, however, Federal family preservation resources are reflexively mobilized on behalf of the abusive parent—cash benefits, the housekeeper, counseling, in-home services, free or subsidized legal services and other resources are all brought to bear to prop up that dysfunctional single parent. Generally, the only party who is not legally represented or subsidized by the Federal Government will be the very relative who reported the child's need and offered himself as a rescuer in the first place.

One simple but critical reform is to recognize that family preservation is not limited to the single-parent household, but includes the blood relatives of the extended family or kinship network. Whether it is the father, the grandparent or the aunt who seeks to be part of the answer for the child's needs, the government is wrong when it defines family preservation to exclude these relatives and actually mobilizes its own resources to resist their involvement.

The tunnel vision that afflicts current family preservation efforts can be seen at all stages of the child welfare process. It is rare for a caseworker even to seek the identity of the child's father, and almost unheard of for the caseworker to seek information regarding the father's fitness and willingness to provide for the child's needs. Too often, we ask only, can that father send a check. We don't look at that father as a human being, as a parent, as a physical and emotional resource for the child. If the father or another relative independently comes forward in an effort to assist the child, the caseworker's standard response is to resist rather than embrace the assistance. This resistance is wrong.

The government's interest is in protecting the child and not in defending one parent's ownership of that child against all others. Family preservation must be understood to include and encourage the participation of all family members, and must move beyond the mere administration of programs designed to prop up the single parent as a stand-alone entity.

Now, Madam Chairman, I have a number of specific responses or ideas in response to Congressman Matsui's request, which I will save for the question and answer period. But just to conclude briefly, the committee recognizes the broad differences among State programs. One of the things that we do wrong now is to measure State performance in terms of the number of Band-Aids they count and

administer; we are measuring how many Band-Aids rather than how much healing.

We need to change the 427 review process to look at the extent to which child welfare is enhanced. We need to look at whether the child's safety is improved, whether the child's behavior is improved, and whether the child's school performance has improved.

Madam Chairman, I look forward to the question period. Thank you.

[The prepared statement follows:]

TESTIMONY OF THE CHILDREN'S RIGHTS COUNCIL
BEFORE THE UNITED STATES HOUSE OF REPRESENTATIVES
COMMITTEE ON WAYS AND MEANS, SUBCOMMITTEE ON OVERSIGHT
JANUARY 23, 1995
PRESENTED BY RONALD K. HENRY

The Children's Rights Council thanks the Chair and Committee Members for scheduling this very important hearing on reform of the federal role in child welfare programs.

The Children's Rights Council is a non-profit, educational organization whose sole purposes are the encouragement of family formation, family preservation, and the "demilitarization" of divorce.

In providing services to children, we must always begin with the understanding that the best service we can provide to "at-risk" children is to reduce the number of children who become "at-risk". Regardless of the social pathology that is under study, whether it be teenage pregnancy, drug abuse, suicide, low self-esteem, juvenile delinquency, poor academic performance, or any of our other social ills, the greatest causal factor is family breakdown or family non-formation.

Virtually all of our social welfare programs are band aids and tonics to treat our childrens' afflictions. The intact two parent family is the immunization program that reduces the tragic needs for band aids and tonics. Too often, our government programs have forgotten the simple axiom that prevention is better than treatment. This hearing on family preservation programs specifically demonstrates the need to reform government programs that focus on treating symptoms while leaving the cause of the symptoms in place.

In virtually all of our programs, the phrase "family preservation" has become narrowly defined to mean the propping up of the single mother household as a stand-alone entity. While most single parents do all they can for their children, and many children of single parents develop beautifully, the inescapable history of our programs demonstrates that many single mother households will never succeed as stand-alone units and many children in those households are in grave danger, both physically and developmentally.

THE KINSHIP CARE ALTERNATIVE

The typical "at-risk" child enters the child welfare system as a result of an abuse and neglect complaint or at the request of the single custodial parent. Many of the abuse and neglect complaints are initiated by other family members who observe and are concerned about the child's status. Before addressing positive steps that can be taken by the government that can aid the child, we must be sure to obey the physician's creed of "First, do no harm."

When the federal government's narrow definition of "family preservation" is heavily oriented toward defending the single parent custodial household, the federal intervention can actually prevent an improvement in the child's situation. Take, for example, the sadly all too common case of an abusive or neglectful parent who is reported to authorities by other relatives such as the grandparents. The grandparents are concerned about the welfare of the grandchild and are frequently willing, eagerly or reluctantly, to provide rescue in their own home. Rather than obeying the physician's creed, however, federal "family preservation" resources are reflexively mobilized

on behalf of the abusive parent. Cash benefits, counseling, in-home services, free or subsidized legal services, and other resources are brought to bear to prop-up the dysfunctional single parent. Generally, the only party not legally represented and subsidized by the federal government will be the relative who reported the child's need and offered to serve as a refuge. One simple but critical reform is to recognize that family preservation is not limited to the single parent household but includes blood relatives in the extended family or "kinship" network. Whether it is the father, the grandparents, or the aunt who seeks to be part of the answer to the child's needs, the government is wrong when it defines "family preservation" to exclude these relatives and actively mobilizes its resources to resist their involvement.

The tunnel vision that afflicts current "family preservation" efforts can be seen at all stages of the child welfare process. It is rare for a caseworker even to seek the identity of the child's father and almost unheard of for the caseworker to seek information regarding the father's fitness and willingness to provide for the child's needs. If the father or another relative independently comes forward in an effort to assist the child, the caseworker's standard response is to resist rather than embrace the assistance. This resistance is wrong. The government's interest is in protecting the child and not in defending one parent's ownership of that child against all others. "Family preservation" must be understood to include and encourage the participation of all family members and must move beyond the mere administration of programs designed to prop up the single parent as a stand-alone entity.

The absurdity of the current system is even more starkly highlighted in situations where the caseworker realizes that the child must be taken from the care of the single parent. In every state in the country, the standard operating procedure is for the bureaucracy to skip over the entire extended family and consider only third party placement. The bureaucracy's fallacy is in viewing child placement as a simple dichotomy -- an unfit single parent versus third party foster care or adoption. Kinship care needs to be recognized as the broad middle on the continuum of options between single parent custody and third party placement.

While the Committee recognizes broad operating differences in the programs and procedures among the various states, the above prejudices and irrationalities have become a universal outgrowth of the current, narrow federal view of "family preservation." If child welfare programs remain federally directed, "family preservation" must be clearly redefined to embrace and encourage fathers, grandparents and other relatives as child rescuers. If the states are given block grants, the federal government must assure that its responsibility for having created this bias is countermanded in the block grant terms in order to assure that the block grants do not merely perpetuate the status quo.

Regardless of the form given to new child welfare programs, the federal government must change its method for the measurement of program success. Like many federal programs, the 427 review process examines the number of band-aids that have been applied to the wounds rather than the amount of healing that has taken place. In 427 reviews, the states are asked to disclose the number of band-aids and give a description and explanation of those band-aids. What is needed in reforming the

427 process is an evaluation that looks at those things that actually matter in the lives of children:

- Has the child's safety improved?
- Has the child's behavior improved?
- Has the child's school performance improved?

We know that the states are capable of running programs that use lots of band-aids. The federal government's evaluation system needs to be structured to incentivize the states not simply to devote more resources to the problem but to devote the available resources to those things which measurably improve child well being.

Kinship care is a resource currently overlooked by the too narrow definition of "family preservation". Kinship care does not create any new legal obligations, it merely embraces the voluntary love and resources of the family. Kinship care saves money. Unlike foster care providers, kinship care providers need not (Lipscomb v. Simmons, (9th Circuit, April 27, 1992)) and should not (to avoid improper incentives) be paid a salary in caring for their own kin. Kinship care improves child well being, reduces spending, and reduces government intrusion by promoting true family preservation.

The remainder of this testimony describes the overview of the Children's Rights Council's approach to welfare reform with particular emphasis upon the methods by which kinship care can become an important part of the solution in AFDC cases as well as in child welfare cases.

WELFARE REFORM INTRODUCTION

It is time to reform welfare. We must change the systems under which our only criteria are that beneficiaries must continue to neither work nor marry. Children are harmed when the unintended consequence of policy is to favor non-working, single parent households over all others. Most law-abiding citizens work 40 to 45 years to qualify for a social security benefit that is smaller than a teenager's welfare package.

Welfare reform requires attention to four areas: responsibility, paternity, accountability, and eligibility.

Responsibility. Every welfare recipient should be required to devote 40 hours per week to some combination of job search, training and work, with a strong emphasis on work. Revising current programs to end the existing discrimination against two-parent families will also increase access to child-care from both parents and reduce the cost of day-care needs.

Paternity. Current policy fails to distinguish between "runaway" and "thrown away" or "driven away" parents. Successful paternity establishment requires that fathers must be accepted and respected in all programs as family members rather than merely as cash donors.

Accountability. Prior efforts at reform have been reluctant to impose sanctions against uncooperative and irresponsible adults because of a fear of "punishing the child." The reality is that current policies allow children to be held as hostages to guarantee continued subsidy of adult irresponsibility.

Eligibility. Minor parents must live with or at the expense of their own parents. Income based eligibility standards should consider both the income of the parents and the resources

that are voluntarily available from the kinship network. Fraud must be addressed as a serious matter.

The following pages provide:

(1) an Overview of Principles and Programs (pages __ to __);

(2) a proposal for kinship care as an alternative to government care (pages __ to __);

(3) a proposal to end federal pre-emption of state law regarding teenage births (pages __ to __);

(4) a proposal for allocation of the dependent tax exemption (pages __ to __); and

(5) a proposal for dealing with program fraud (pages __ to __).

A. OVERVIEW OF PRINCIPLES AND PROGRAMS

There is widespread agreement that the current welfare system is destructive of the families it was intended to help. Despite its good intentions, the government has made a devil's bargain with the poor -- "We will give you money as long as you continue to neither work nor marry." Current programs and many reform proposals are patronizing. They assume that large classes of citizens are simply too stupid and incompetent to make any current or near term contribution to their own support. Real welfare reform requires recognition that there is no respect for the individual unless there is respect for the individual's labor.

1. "Making Work Pay": Rhetoric and Reality

Work always pays. Our problem is that we have established a parallel system under which non-work often pays better. Most law abiding citizens work 40 or 45 years to qualify for a social security benefit that is smaller than a teenager's welfare package. Many welfare recipients are not unemployed, they are prematurely retired. We have long recognized that Social Security rules discourage paid employment among senior citizens. We have recently recognized that welfare rules discourage paid employment among welfare recipients. The cornerstone of welfare reform must be respect for the importance and dignity of work. Except for the small number of people who are genuinely unable to make any contribution to their own needs, welfare must be a supplement, not a substitute for work.

Welfare reform requires attention to four areas: responsibility, paternity, accountability, and eligibility.

2. Responsibility

Responsibility should be immediate, mandatory and universal. Beginning immediately with entry into any welfare program, every recipient should be required to devote 40 hours per week to some combination of job search, training and work with a strong emphasis on work. Actual work experience is generally the best training for advancement in the work place. An immediate, universal work requirement also eliminates the "no job" option and encourages serious search efforts for the best available job.

The work requirement can be satisfied by private employment or by unpaid public service in exchange for receipt of the welfare benefit. Work programs should not discriminate against the non-welfare working poor. Vouchers and other special incentives to hire welfare recipients create the risk of displacing other workers. We should not support programs that have the unintended consequence of encouraging people to enter welfare as the path to job preferences. Community service jobs (e.g., assignment to charitable organizations) provide benefits to the community and training to the employee at little or no government cost. Many of the current, unmet needs of communities can be satisfied by this new pool of labor as a supplement to, rather than a substitute for, current employees.

All programs must be open to and end the current discrimination against two parent families. In two parent families, at least one parent must satisfy the 40 hour requirement.

Welfare reform should also begin the process of examining barriers to entry-level job creation. Many worthy tasks in society are not performed because the total cost of obtaining labor, including regulatory and recordkeeping burdens, exceeds the value of the service. We need to examine the extent to which willing workers have been priced out of the market by government mandates.

Child care may be less of a problem than argued by some. Most current working parents utilize some low-cost combination of family, friends and school to satisfy day care needs. As discrimination against two parent households is eliminated, a greater number of children will have access to child care from both parents. Finally, a portion of the community service assignments can be made to child care organizations to increase the available supply at little or no incremental cost. The Head Start Program already utilizes large numbers of low income parents who begin as unpaid interns and progess to paid staff and supervisory positions.

3. Paternity

Current policy fails to distinguish between "runaway" and "thrown away" or "driven away" parents. The federal government spends approximately two billion dollars per year on child support enforcement but purposefully and consciously excludes fathers from all parent-child programs. Under current AFDC rules, the low income father who wishes to be a physical and emotional asset to his children also becomes a financial liability by disqualifying them from most assistance. Research conducted by HHS itself confirms that both mothers and fathers distrust the bureaucracy and work jointly to conceal paternity. We cannot be surprised by low income parents who separate or conceal paternity when our policies make such behavior the economically rational course. A work requirement for single parents and an end to discrimination against two-parent households will change the dynamics of paternity establishment.

Eligibility for all federal programs should require establishment of paternity, beginning with eligibility for the WIC program. That program itself must be revised to develop and encourage the roles of fathers.

Paternity establishment forms in hospital programs should encourage the parties to voluntarily establish custody and visitation as well as financial support. Avoidance of poverty and welfare dependency are directly linked to father involvement. Child support compliance exceeds 90 percent in joint custody families. Child poverty rates and welfare dependency rates are much lower in father custody families than in mother custody.

Women's workforce participation and economic security are increased in joint custody and father custody families.

4. Accountability

AFDC and other programs are intended for the benefit of the dependent children. Adults receive the benefits and are expected to participate in the programs in support of the children's needs. Failure or refusal to participate in required programs or to spend the cash payments for the benefit of the children should be seen as evidence of child neglect or abuse. Such evidence should weigh heavily in determining whether it is in the best interests of the child to transfer custody to a more responsible relative or to consider a foster care placement. Prior efforts at reform have been reluctant to impose sanctions upon uncooperative and irresponsible adults because of a fear of "punishing the child." The reality is that current policies allow children to be held as hostages to guarantee continued subsidy of adult irresponsibility.

All recipients should be required to reimburse the value of benefits received. Currently, child support paid by non-custodial parents is used for reimbursement after a $50 per month waiver. The custodial parent should have the obligation to reimburse one-half of the welfare payments made on behalf of the child and each adult should have the obligation to reimburse benefits paid on behalf of that adult. Many welfare recipients require only short term assistance and that assistance can fairly be treated as a loan or a line of credit rather than as a grant. A uniform reimbursement requirement also encourages all recipients to minimize the period of dependency, take no more benefits than are required, and resume paid employment at the earliest possible date. Community service should be counted toward the reimbursement obligation but should be valued at a level that does not compete with the attractiveness of paid employment.

5. Eligibility

Under the law of each state, parents have an obligation of financial responsibility for their minor children. If the minor children themselves become parents, the minor parents should continue to be the obligation of their own parents. Accordingly, the birth of a child to minor parents may create a requirement for welfare assistance to the new infant but does not create a requirement for assistance to the minor parents unless their own parents are unable to supply the required support. Minor parents must live with or at the expense of their own parents. Payments on behalf of the new infant should be made to the parents of the minor parents as their guardians.

Welfare payments should be limited to citizens and immigrants with refugee status.

Income based eligibility standards should consider both the income of the parents and any resources that are voluntarily available from the kinship network. See attached proposal for more details.

Fraud must be addressed as a serious matter. Welfare benefits are based on the applicant's self-reporting of available income. If welfare fraud has concealed additional income, welfare eligibility must be recalculated, at a minimum, to include the demonstrated capacity for self support. See attached proposal for further details. Other fraud reduction mechanisms including electronic transfers and improved identification verification must be adopted.

The earned income tax credit must be modified to reduce the incentive and opportunity for strategies such as over-reporting of income to maximize benefits and to reduce discrimination against two parent families. Currently, many working class couples are ineligible for EITC but, simply by splitting into two dysfunctional fragments, both become eligible.

B. WELFARE ELIGIBILITY -- KINSHIP ALTERNATIVES TO WELFARE

There is a broad consensus that welfare dependency is not in the best interests of children. Recent legislative initiatives have begun to examine the structural flaws in existing welfare programs. One of the best opportunities for reducing welfare dependency is to be found in the development of more thoughtful eligibility criteria to better identify the children who are actually in need of welfare assistance.

Currently, most welfare programs look only at the cash income of the custodial single parent without regard to the availability of voluntary kinship or extended family assistance. The attached proposal provides that welfare eligibility should be determined by examining all resources that are available voluntarily through the child's kinship network.

The proposal does not relieve the child's parents of their obligations nor does it impose new obligations on other relatives. Only voluntary kinship assistance is considered.

Examples:

- Brother is willing to care for child of drug abuser with or without change of custody/guardianship. Welfare dependency is not in the best interests of the child and eligibility should be denied.
- Father of child is willing to provide child care with or without change of custody while mother works. Welfare dependency is not in the best interests of the child and eligibility should be denied.
- Adolescent mother lives with her parents. The parents have a legal obligation to support their adolescent daughter and are willing to care for grandchild while daughter completes school or works. Welfare dependency is not in the best interests of the child and eligibility should be denied.

KINSHIP CARE ACT OF 1995

SECTION ONE FINDINGS AND PURPOSES

The Congress of the United States finds that:

Welfare programs are intended to provide temporary economic sustenance for individuals while they seek to enter the workforce and eventually extricate themselves and their dependents from poverty.

Welfare programs have fallen short of this goal as many individuals receiving assistance fail to find and retain jobs.

The failure to escape poverty persists through generations as children of welfare families go onto welfare rolls as adults, resulting in a needless waste of human potential as well as economic and other costs to society.

A primary cause of intergenerational welfare dependency is the adverse impact of the welfare environment upon children.

To break intergenerational welfare dependency requires, where possible, the separation of children from the welfare environment and their placement into family situations that will be conducive to rejection of the welfare career.

Current welfare provisions lack measures that would assist in the elimination of intergenerational welfare dependency and, indeed, actually encourage such dependency by ignoring the availability of non-welfare alternatives for dependent children.

It is therefore in the public interest to amend the welfare laws to eliminate the encouragement of intergenerational welfare dependency and to promote the placement of children in non-welfare environments more conducive to an economically and socially productive adulthood.

SECTION TWO **AMENDMENT TO PUBLIC LAW NO. _____**

Section _____ of Public Law No. _____ is hereby amended to add a new subsection _____ as follows:

Subsection _____:

No person shall be eligible to receive benefits under this program by reason of the need of that person to support one or more child dependents unless the administrator *[or agency or other appropriate state official]* has certified, after undertaking diligent efforts, that there are no family members who are fit and willing to provide for the needs of such child without resort to welfare dependency. Such certification shall be required prior to initial entry into the program and, thereafter, upon periodic reviews of eligibility conducted annually.

C. TEENAGE PARENTS - WELFARE ELIGIBILITY

Under the law of each state, parents have an obligation of financial responsibility for their own minor children. If the minor children themselves become parents, these minor parents should continue to be the obligation of their own parents.

Current welfare eligibility rules subvert this basic rule of parental responsibility and create perverse incentives for teenage child bearing. Simply by having a child, federal programs give the teenager an independent income source and relieve the teenager's parents of the obligations imposed by state law.

Under state law, a minor must live with or at the expense of his or her own parents. The birth of a child to that minor should not be a basis for the federal government to override state law. The federal government should not subsidize the establishment of independent households by minors.

If the parents of the minor are already on public assistance, their payments should be governed by the rules applicable to other families experiencing the birth of an additional dependent. If the parents of the minor are a danger to the minor or grandchild, the case should be processed under the normal rules of guardianship used by the state. Again, there

is no justification for a federal program which automatically establishes all minors as independent households upon the birth of a baby.

D. DIVORCED FAMILIES - DEPENDENT TAX EXEMPTION

Prior law provided that the dependent exemption for a child of divorced parents was available to the parent providing greater than 50% of the child's support. At that time, it was difficult to determine which parent provided greater than 50% of the support and the law was changed in 1984 to create a presumption that the exemption would be given to the custodial parent. The current law has created some new problems and has not kept pace with federally imposed changes in the establishment of child support orders.

Most divorce litigants do not have lawyers and, even with lawyers, most divorce decrees fail to address the allocation of the dependent tax exemption. Some courts have taken the position that they do not have authority to allocate the exemption to the non-custodial parent even in cases where the custodial parent is unemployed and it is clear that the non-custodian is providing 100% of the child's financial support. Allocating the dependent exemption to a household with no income does not help the child and, in fact, reduces the after-tax income available to support the child.

Recent federal legislation governing the establishment of child support orders has eliminated the uncertainty which motivated the 1984 law regarding allocation of the dependent exemption. In the past, child support orders were subjective, ad hoc determinations that did not identify each parent's share of the child's financial costs. Federal law now requires that each state have a presumptive, mathematical guideline for the establishment of child support. Under the "income shares" model used by most states, the state determines a child's costs and then allocates these costs in proportion to each parent's income. The child support computation formula thus establishes unambiguously which parent provides more than 50% of the child's financial support.

The law should be revised to provide that the dependent exemption shall be allocated to the parent who bears more than 50% of the child's financial support as established by the applicable child support order. To avoid ambiguity and dispute, the taxpayer claiming the exemption could be required to submit a copy of the court order as an attachment to the tax return. Most child support orders are now generated by computers using the state's child support formula and are set forth in a one page computer printout.

E. RESPONDING TO WELFARE FRAUD

In the District of Columbia and in most states, welfare fraud is a no-risk adventure.

If caught, the standard guilty plea merely requires restitution (sometimes only partial) which is paid out of future welfare benefits! Welfare is a disastrously anti-family program in which the government offers itself as a substitute for responsible two-parent family behavior. Welfare fraud multiples the problem by making welfare more lucrative.

Welfare benefits are predicated on the assumption that the welfare recipient cannot earn an outside income and that a government subsidy is required for basic needs. Initially, we accept the applicant's unilateral assertion of this inability to earn an income. In the case of the welfare cheat, however,

behavior proves that an income can be earned and the receipt of welfare benefits is simply a theft of benefits that are not needed. Having proved that an income can be earned, the welfare cheat should be disqualified from receiving benefits in the future at least to the extent of the earnings potential that has been demonstrated.

Past enforcement efforts have been backward. The welfare cheat is permitted to quit the unreported job and go back to the dole. The reverse should be true. Having demonstrated earning capacity, the welfare cheat should be disqualified from again asserting an inability to earn income.

In the current economic crisis of budget deficits and soaring welfare rolls, it may finally be possible to impose serious sanctions upon welfare cheaters. The following legislative suggestions are offered:

1. The presence of unreported income means that the welfare cheat either does not need or has less need for welfare. Accordingly, the law should provide that welfare benefits will be reduced or eliminated on a forward-going basis to reflect the income that was being earned during the fraud and thus can be earned in the future.

2. State laws providing for mandatory jail terms of not less than 30 days for all persons convicted of welfare fraud should be required as a condition for a state's receipt of federal funds.

3. State laws providing that conviction for welfare fraud is a sufficient basis to support a judicial finding that it is in the best interests of the child for custody to be placed with another relative should be required as a condition for a state's receipt of federal funds.

4. State laws providing that conviction for welfare fraud is a sufficient basis to support a judicial finding of neglect or abuse so that the child may be placed in foster case should be required as a condition for a state's receipt of federal funds.

Chairman JOHNSON. Thank you. We appreciate your comments. Dr. Berger.

STATEMENT OF BRIGITTE BERGER, PROFESSOR OF SOCIOLOGY, BOSTON UNIVERSITY, BOSTON, MASS.

Ms. BERGER. Thank you very much.

I am a sociologist who has worked in family issues for a long time. I have written a number of books on these issues, including issues of child care, foster care, and the care of handicapped and severely disabled children. I could easily have talked about these issues to this committee. However, the Postal Service's—the Federal Postal Service's Specialty Express Service does not function as well as one would expect. So you have to make do with what I have to say today, which is slightly different from what the charge from the Chair has been.

The purpose of my testimony is to strongly endorse making use of largely unrestricted block grants in the overhaul of the national welfare system and to urge this committee not to fall prey to the fatal error to cast the issue of welfare reform in political and economic terms only.

A large set of data available to us today compels us to recognize that three decades of Federal intervention has resulted in the creation of a new culture of relative dependency at the bottom of American society that is stubbornly resistant to simple administrative and economic measures. It is therefore of singular importance, to my mind, to recognize that welfare today is threatened by the cultural dimensions of welfare dependency; and if you wish to make a dent in the, by now, deeply entrenched welfare culture, you will have to make use of culture-changing measures.

Block grants, in my opinion, offer a first and perhaps only available mechanism. In my written testimony, I provide the more detailed rationale that has led me to this conclusion.

I have first reviewed the data that show how we have gotten ourselves into this welfare mess. And while I do not wish to throw aspersions around—we all have to share blame together—there is no doubt in my mind that the phenomenal explosion of welfare rolls coincides precisely with the plethora of grants and programs that Federal intervention has dispensed.

The second point, then, which I am addressing, is why is that so in spite of the enormous amounts of money we have spent on these issues. And here I have come to a conclusion, which is as simple as it is straightforward.

I do think that Federal programs have unintentionally circumvented precisely those social mechanisms and factors which make for the spontaneous growth of a productive culture. As you can see, I take culture very seriously; and again in my testimony I take some pains to spell out how culture functions and, in particular, how in the absence of what I call "the mediating institutions" of the family, neighborhood and ethnic organizations, and the churches—the American welfare population has been deprived of its most important help.

The next point which I am trying to make here is that with the wisdom of hindsight we cannot help but come to the conclusion that Federal efforts have largely served as conduit and reinforce-

ment of the dysfunctional social norms leading to the consolidation of a dysfunctional welfare culture, which we are now called upon to address.

Now, how do we get out of this mess? And that is the next point which I am spelling out in my detailed presentation you have before you.

I think it is important to recognize there are no easy panaceas. Once the social fabric has been torn, there is very little the government, at any level, can do but prevent the worst from happening. If there is any hope for turning the present situation around, we are obliged to return to precisely those ground level mechanisms that have proven to be useful in providing structure and meaning to individual life—the family, the community, and religion.

I have written a lot about the role of the family. And everything I have heard so far at these hearings confirms my own findings that the past welfare practices have conveniently bypassed the family. It is only very recently that we have rediscovered the family, and then only by trying to superimpose all kinds of restrictions on its normal functioning. Nonetheless, it is very important that we recognize as well that the present welfare population—mostly women and children, single women and children—cannot help themselves and need some kind of support. What kind of support? Community support, voluntaristic, spontaneous groups that exist in every community, the support of the churches.

Now, I want to come to an end very quickly. I spell this out, if and how it can be done. The most critical point which I make in my testimony is this connection, one that I know will raise a lot of problems to this committee, is that I wish to urge that block grant mechanisms will allow religion to do its good work as it has done in the past. I know that I am getting into conflict with the first amendment and the way it has been interpreted since the sixties. I do think we can reverse some of these questions and problems by returning welfare to the State level. On the local level, where everyone is involved, these issues will have to be sorted out in a responsible manner. I have no doubt that all citizens can do that.

[The prepared statement follows:]

Brigitte Berger
Professor of Sociology
Boston University

Testimony before the House Ways and Means Committee - January 23,1995

Re: **Block Grants**

Mr. Chairman, Members of the Committee: Permit me to thank you for the opportunity to testify before this Committee. I am here today in a dual capacity: first as a sociologist located at Boston University, who has worked and written on issues relating to the social institution of the family and the community, and second, as a member of the Advisory Board of the Massachusetts based Pioneer Institute, an independent, nonprofit research organization funded by individuals, corporations, and foundations. While I cannot officially speak for this Institute, I know that my thinking reflects that favored by it.

The purpose of my testimony is to strongly endorse the making use of largely unrestricted block grants in the overhaul of the national welfare system and to urge this Committee not to fall prey to the fatal error to cast the issue of welfare reform in political and economic terms only. A large set of data available today compells us to recognize that three decades of federal interventionism has resulted in the creation of a new culture of welfare dependency at the bottom of American society that is stubbornly resistant to simple administrative and economic measures. It is therefore of singular importance for us to recognize that welfare today is driven by cultural dimensions of welfare dependency. If we wish to make a dent in the by now deeply entrenched and continually spreading welfare culture we will have to make use of culture-changing measures. Block grants, in my opinion offer us the first, and perhaps only available mechanism, for getting the country out of the current welfare mess.

The frightening statistics on factors making for the phenomenal rise of the welfare rolls - illegitimacy, teenage motherhood, single parenthood, delinquency, crime and substance abuse

- are only too well known for me to comment on here. By the same token, it is equally well known that the same period that saw the componential increase of children and women on welfare coincided with the explosion of a plethora of federal child welfare programs - family planning, prenatal and postnatal care, child nutrition, child abuse prevention and treatment, child health and guidance, daycare, Headstart, and many more in addition to the "big three" (AFDC,Medicaid, and Food Stamps). Both individually and collectively most, though not all, of these programs have fallen way short of producing the desired effects. The growing number of children growing up in poverty are not measurably better off today than they were some thirty years ago and all too many seem to be trapped into a life of poverty. Well-intentioned governmental programs appear to have accomplished little more than making child welfare a purview of the federal government, with governmental coffers disgorging ever larger amounts of money, and with no limits in sight.

Time and again it has been demonstrated that this new welfare culture exerts not only an intolerable drain on the national economy, but equally importantly, it is destructive of individual human lives. What is more, the new culture of welfare dependency is morally unacceptable and fraught with perils for the nation's future. While the block-granting mechanism in and by itself cannot provide us with ready-made panaceas, it is a very important first step toward genuine welfare reform.

This line of argumentation, I would propose, is as commonsensical as it is straightforward. Once a culture - that is the ways in which people behave, their values and their lifestyles - has come into existence, it starts to take on a dynamics of its own. And once this has happened, it is extremely difficult to change. If lifestyle changes can be brought about at all, then certainly not by government fiat. The bitter experience of the past decades have brought into start relief the impotence of the federal government for this task. If productive cultural changes could be brought about simply by a combination of good intentions, money, and an active involvement on part of the federal government, then surely the cornucopia of federal programs that have been institutionalized across the country in the course of the past decades should have done the trick. The term "culture" as used in the social sciences, however, though

not mysterious is something much more complicated. It is the spontaneous production of collective social life arising at the intersection of family, work, and voluntary associations taking place in any society. The problem with the existing welfare policies is that they have discouraged precisely these elements vital to the productive functioning of culture to do their work.

Permit me to elaborate this argument briefly. The welfare dependency culture that has taken roots in the wasteland of America's inner cities is a culture in which the game of social life is played out between isolated individuals at the bottom of society and the large, distant bureaucracies of the welfare state at the top. The federal policies of the past decades have bypassed the elements that traditionally mediate between the individual and the distant state, the family and voluntaristic institutions, such as informal neighborhood and ethnic associations and the churches. In the absence of the vital input flowing from these mediating institutions, an anomic culture of dependency has been forged which prevents individuals from developing habits of self-reliance and the capacity to plan for a future independent of government hand-outs, just as it prevents those trapped in it from taking advantage of existing educational and job opportunities. It is a culture characterized by fatalistic attitudes and chaotic lifestyles, a culture in which the language of entitlement has replaced the language of responsibility. It is contagious and produces a social ethos that stands in direct contradiction to precisely those norms and values that have made for America's strength in the past. Contrary to all intentions, the welfare system in its 1960s liberal mode has cut all too many people loose from their familial moorings, has isolated them from communal ties, deprived them of the spiritual and moral guidance of religious institutions and driven them into an existential and psychological dependency on the state.

It would be unfair to put the blame for the rise of the new welfare dependency culture on federal intervention policies only. Broad and poorly understood shifts in the normative order of society have transformed all segments of twentieth-century America with cataclysmic speed regardless of their location in the social hierarchy. Yet despite a general discrediting of traditional virtues, the American middle classes have been able to withstand the most harmful

effects of the turbulent 1960s and 1970s. Those living at the bottom of society have not. While massive federal interventionist practices may not have been solely responsible for the creation and diffusion of welfare dependency, it is safe to argue that they certainly were instrumental in giving expression and shape to its formation. Hence it is legitimate to conclude that America's welfare classes are not primarily victims of an unjust economy or a neglectful government. Rather, they are the victims of both general shifts in the normative order as well as ill-conceived interventionist efforts, the consequences of which neither the poor nor their welfare mentors expected. With the wisdom of hindsight, it is heartbreaking to observe that these well-intentioned federal efforts largely served as conduit and reinforcement of dysfunctional social norms leading to the consolidation of a dysfunctional welfare culture which we now are called upon to undo.

There are no easy panaceas for achieving this monumental task. Once the social fabric has been torn, there appears to be precious little government can do but prevent the worst from happening. If there is any hope for turning the present situation around, we are obliged to return to those ground-level mechanisms that have a proven track record in providing structure and meaning to individual life, namely the social institutions of the family, the community, and religion.

Let me here say only a few things about the role of the family. Common to all current debates on welfare reform is the rediscovery of the central importance of the traditional family of father, mother, and their children, tied to each other by bonds of mutual affection and obligations, living and striving together while pooling their resources. This rediscovery is fairly recent and it pains me to say that federal policy in its 1960s mode has done more than its share in discrediting the traditional family. Although two-parent families still form about half of the households below the poverty line at any given point in time, they rarely stay in poverty for extended periods, nor do they often show up among the homeless. Children in two-parent families have a better start in life than children from single-parent households where fathers are totally absent or play only a minimal role in their lives. A huge set of data collected over the past decades has led to the insight that welfare dependency, along with a

host of other pressing domestic problems such as rampant youth crime and the catastrophic failure of public education, is rooted in profound shifts in both the structure of the American family as well as its moral code. Statistics on separation, desertion, divorce, and illegitimate births document the collapse of the two-parent family among the welfare-dependent class. More qualitative research points to far-reaching changes in the welfare population relating to the commitment to the family as an institution, attitudes toward work and authority, and the ability to defer gratification. Together these shifts have fused into a devastating amalgam of influences with important consequences for the growing number of the persistently poor.

How we can turn this situation around is then one of the most pressing questions before the nation. The children and women of the welfare dependency class are certainly unable to achieve this on their own, nor will merely punitive governmental policies help those who are too young to help themselves. A vast social science literature attests to the capacity of religious and other more informal institutions arising at the level of the community in bringing about changes in the values and behavior of individuals and groups. The important role of mediating institutions has been recognized for long. Unfortunately, they have frequently been misused by policy experts sitting at distant planning boards. The community organization programs designed by the poverty warriors of the 1960s and 1970s may serve as a somber warning of the futility of policies that parachute programs - and their organizers - into communities of which they have little knowledge, while ignoring precisely those institutions that stand at the core of all individual and communal life. In divorcing the issue of welfare from the exigencies of family, informal community dynamics as well as from the accepted standards of morality, these 1960s programs merely served to turn welfare into a support system individuals have learned to feel entitled to, irrespective of their lifestyle choices. When we turn today once more to local initiatives, we will do well to remember the disastrous history of past efforts that circumvented precisely those forces that alone are able to make for stable and productive community dynamics.

There is no question about the necessity for government to protect and provide for children and the weak who cannot rely on those who should be their natural protectors and providers.

In the face of the overwhelming evidence from the grim experiences of the past, however, it is more than doubtful that federal bureaucracies located in Washington are up to the task. Although it goes without saying, that basic individual rights must be guaranteed and enforced on the national level, decentralizing public power from the federal government and shifting it to smaller units closer to the targeted problems make eminent sense. **I think it therefore of great importance that block grants to the states come with as few restrictions as possible.**The precise mix between federal restrictions and mandates, on the one hand, and the discretionary power of individual states, on the other, is still an open question and will have to be carefully worked out. Yet one thing is already perfectly clear today: federal interference must be kept at a minimum. In the absence of any fool-proof recipes for the reduction of the current welfare dependency culture, states must be allowed and encouraged to explore and experiment with initiatives and programs best suited to deal with local, and frequently distinctive problems. Only in this manner can efforts be identified that not only hold the potential for changing welfare-dependent behavior and that simultaneously hold the potential for creating dynamics productive of community development.

Fears have been voiced in recent weeks that without the protection of federal entitlement legislation the poor will be at the mercy of uncaring states and mean communities. Such fears sound hollow in the face of strong evidence to the contrary. This nation, more than any other I know, can be rightly proud of its voluntaristic tradition. It is this tradition that has made for America's strength and uniqueness. An extraordinary degree of compassion, of responsibility, and tolerance continues to thrive today in all sectors of American society from coast to coast. Not to provide considerable discretionary powers to the states, would, from the perspective I aargue here,, severely defeat the very purpose of the block grant initiative. Most important, such federal restrictions would in all likelihood interfere with the culture-building dynamics needed for achieving genuine and lasting welfare reform.

My recommendation that block granting should not be burdened by undue federal restrictions is further informed by the recognition of the important role religion plays in the transformation of individual values and behavior. We know from the data available to us -

and our experience reinforces this knowledge - that nothing can compete with religion in effecting lasting changes in the behavior of individuals. The utilization of religion to this end, however, runs directly counter to the highly secularist interpretation of the First Amendment that has been favored by the courts since the early 1960s. While nothing is further from my mind than to argue for some new establishment of religion by the state, I think it of some importance to ensure that the law does not inhibit states from making use of the guidance and sustenance-providing capacity of the very institution central to the life of most Americans. The historical evidence of the role religious institutions have played in incorporating generations of poor and destitute people into the mainstream of American society is too well known to this gremium to be trotted out once more.

My recommendation that also present-day federal legislation should not unduly interfere with the opportunity to make use of religion's behavior-changing and culture-building potential will, undoubtedly, lead to a major political battle. The fate of America's welfare population, however, demands immediate action and cannot wait for the outcome of prolonged disputes. Unrestricted block grants to the states, I would argue, allow for a renewed deliberation and sorting out of church-state issues in more manageable settings. On the basis of all we know, we have good reason to hope that the responsible and compassionate citizens of all states of the Union will arrive at formulas that will not deprive today's poor of the benefits of religion in their search for a purposeful and meaningful life.

My support of block grants then is informed by considerations among which the identification of mechanisms that promise productive changes in the current culture of welfare dependency figures prominently. Converting the present federally financed and organized welfare system into unrestricted block grants to the states is the necessary first step in the reversal of a situation in which federal policies designed to aid the poor have unintentionally turned welfare into an institution that feeds on itself. For genuine welfare reform to occur, however, individual states, in turn will have to carry the task of reform yet one step further.A number of states currently working under waivers, have already explored new and promising ways to achieve welfare reform. All states of the Union, I finally would recommend, should be obliged to reach out to municipalities, to businesses, and to private groups in their respective states in order to encourage initiatives of scale consonant with the distinctive needs of their welfare population. Common sense leads us to believe - and the research data confirm it - local and ethically inspired initiatives are our single best hope to bring about the much needed welfare reforms.

Chairman JOHNSON. Thank you very much, Dr. Berger.
Ms. Driver.

STATEMENT OF CORINNE DRIVER, DIRECTOR, NATIONAL ASSOCIATION OF FOSTER CARE REVIEWERS; ACCOMPANIED BY CHARLES COOPER, ADMINISTRATOR, CITIZEN FOSTER CARE REVIEW BOARD, STATE OF MARYLAND

Ms. DRIVER. Honorable hungry Congresspeople, thank you for including citizen volunteers in your discussions. I am Corinne Driver, a volunteer and unsalaried executive director of the National Association of Foster Care Reviewers, a nonprofit organization which promotes citizen review for every child removed from home by the State.

Children play with blocks. Blocks must not play with children. This statement explains citizen review, an existing, dynamic, cost-effective, community-based monitoring system, in which citizens review every child removed from home; promotes ongoing, periodic, independent review for all children in placement; recommends that volunteers can carry out those reviews cost-effectively; suggests that trained, experienced citizens should be empowered to share in holding their tax supported public systems accountable; suggests the 427s made a difference, even though they were woefully inadequate; and recommends that Congress must hold public systems to standards of good case practice and must maintain penalties.

With me is Charles Cooper, administrator of the Maryland Citizen Foster Care Review Board. Charlie represents more than 400 Maryland volunteer citizen reviewers supported by 25 staff. Maryland reviewers conducted nearly 11,000 reviews of individual foster children last year. Nationally, in 1992, 3,500 volunteers reviewed case plans for over 50,000 children.

Before 427 reviews, States did not even know how many children were in their care. States did not have data on children in care. Children were lingering longer in the system than necessary. Costly for the State, yes, but what about the cost to the child? Before citizen review came to New Jersey, which is my home State, the agency was responsible for about 13,000 children. They were not sure. When citizen review came into being 3 years after that, the caseload had dropped to 6,500. Expediting children out of the system saves money.

Citizen review boards exist by virtue of State law or judicial mandate, and usually consist of five trained citizens. I am representing those citizens who can tell of children like Maria, for whom the agency plan was return to her father until she told my review board that for the second time she was carrying her father's child.

Constituents can tell you of children whose biggest problem is bureaucratic policies within the very systems that are supposed to be helping, systems supported by our own tax dollars. If the policy of block granting is to bring decisionmaking closer to home, who better than citizens from home to require accountability?

Citizen review boards examine plans and results for each child in placement. Citizen review boards achieve hands-on accountability for each child, give citizens responsibility for fellow citizens, remove vested interests from foster care decisionmaking, create a

window into and offer accountability for the workings of taxpayer-supported public systems, and empower knowledgeable citizens to work toward improving those systems.

As a trained citizen reviewer under an oath of confidentiality, I went to Newark, N.J., weekly to review confidential records and plans for children and to talk with children, parents, foster parents and caseworkers. We studied the caseworkers' confidential file and previous court rulings. We told them our job was advisory and that our focus was to move children out of foster care and into permanent homes as quickly as possible.

Our periodic reviews often revealed lack of progress, sometimes because no caseworker had been assigned. Often, work on the case began just before our periodic review. Amazing. Often citizen review has impacted on a constipated adoption system where children get stuck.

In Nebraska, home of Boys Town, three separate studies have confirmed that a child is twice as likely to be adopted if the child is being monitored by a citizen review board. Think of the money that saves.

Wade Horn has already cited a Kansas example, and that saves money, too.

Despite imperfect 427s, it was remarkable, as reviewers watched their States take notice of foster care caseloads when their actions were subject to scrutiny and their dollars were on the line. It was wonderful as we watched 427 monitoring enlighten courts about their responsibilities to the foster care population. But bringing decisionmaking closer to home means we must bring monitoring closer to home.

Block grants must build in accountability. The intent and clout of the 427 reviews should be maintained.

I urge you, continue to protect children by requiring independent individual case reviews.

Incorporate in block grant philosophy standards, expectations and accountability for results. Maintain the ability to withhold funding based on documented results. Require States to put in place a strong independent cost-effective monitoring mechanism using trained volunteers, and assign block grant support directly to that monitoring mechanism to assure its independence.

Thank you.

[The prepared statement follows:]

STATEMENT TO THE WAYS & MEANS COMMITTEE
JANUARY 21, 1995

THIS TESTIMONY IS SUBMITTED BY CORINNE DRIVER, A VOLUNTEER AND UNSALARIED EXECUTIVE DIRECTOR OF THE NATIONAL ASSOCIATION OF FOSTER CARE REVIEWERS, (NAFCR), A NON-PROFIT ORGANIZATION WHICH PROMOTES THE ACCOUNTABILITY MECHANISM OF CITIZEN REVIEW FOR EVERY CHILD REMOVED FROM HOME BY THE STATE.

CHILDREN PLAY WITH BLOCKS.
BLOCKS MUST NOT PLAY WITH CHILDREN.

THIS STATEMENT:

- PROMOTES CONTINUING THE PERIODIC INDEPENDENT REVIEW FOR ALL CHILDREN IN PLACEMENT
- SUPPORTS THE INTENT OF 427 REVIEWS
- SUGGESTS THE 427s MADE A DIFFERENCE EVEN THOUGH THEY WERE WOEFULLY INADEQUATE
- RECOMMENDS THAT MONITORING AND PENALTIES MUST BE MAINTAINED WHETHER TITLE IVB AND IVE MONIES ARE BLOCK GRANTED OR NOT
- PROMOTES THE NEED FOR STANDARDS, OVERSIGHT AND ACCOUNTABILITY FOR EXPENDITURE OF TAX DOLLARS
- RECOMMENDS A COST EFFECTIVE MECHANISM, BASED 90% ON VOLUNTEER POWER, TO CARRY OUT THE INTENT OF THE 427 REVIEWS AND PROVIDE THE FEDERAL GOVERNMENT WITH INFORMATION UPON WHICH TO EVALUATE STATE'S ADHERENCE TO PRESCRIBED PROTECTIONS FOR CHILDREN
- EXPLAINS CITIZEN REVIEW, AN EXISTING, DYNAMIC, COST EFFECTIVE COMMUNITY BASED MONITORING SYSTEM IN WHICH TAXPAYING CITIZENS REVIEW EVERY CHILD REMOVED FROM HOME
- RECOMMENDS PROMULGATION TO ALL STATES OF INDEPENDENT, COST EFFECTIVE CITIZEN REVIEW
- RECOMMENDS EMPOWERMENT OF CITIZENS TO HOLD PUBLIC SYSTEMS ACCOUNTABLE BY BLOCK GRANTING DIRECTLY TO STATE CITIZEN REVIEW SYSTEMS
- RECOMMENDS ASSURING QUALITY CONTROL OF CASE BY CASE DATA GATHERING AND EXCELLENT TRAINING OF VOLUNTEERS BY A BLOCK GRANT TO THE NATIONAL ASSOCIATION OF FOSTER CARE REVIEWERS

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WHY DOES CURRENT LAW REQUIRE INDEPENDENT REVIEW OF CHILDREN IN PLACEMENT? BECAUSE:

- STATES DID NOT EVEN KNOW HOW MANY CHILDREN WERE UNDER THEIR CARE
- STATES DID NOT HAVE DATA ON CHILDREN IN CARE
- CHILDREN WERE LINGERING IN THE SYSTEM FAR LONGER THAN NECESSARY--COSTLY FOR THE STATE? YES--BUT WHAT ABOUT THE COST TO THE CHILD!

WITHOUT STANDARDS, INDEPENDENT MONITORING AND FISCAL PENALTIES AND/OR INCENTIVES BUILT INTO BLOCK GRANTS IT IS PROBABLE THAT CHILDREN WILL ONCE AGAIN LANGUISH IN CARE AND CASELOADS INCREASE.

WHEN CITIZEN REVIEW BOARDS BEGAN IN NEW JERSEY IN 1979, ALMOST 10% OF CASES REVIEWED BY MY REVIEW BOARD WERE CHILDREN WHO HAD BEEN IN CARE THEIR WHOLE LIVES--INCLUDING MANY CHILDREN OVER 16 YEARS OLD. MANY OF THOSE CHILDREN HAD BEEN SHUFFLED FROM PLACE TO PLACE BY THE SYSTEM. ONE CHILD HAD OVER 30 DIFFERENT PLACEMENTS!

CITIZEN REVIEW BOARDS
A DESCRIPTION OF HOW THEY WORK

A PRIMARY GOAL OF NAFCR IS TO PROMOTE CITIZEN FOSTER CARE REVIEW BOARDS, A COST EFFECTIVE, CITIZEN BASED ACCOUNTABILITY MECHANISM FOCUSED ON CHILDREN IN PLACEMENT.

WHAT IS A CITIZEN REVIEW BOARD? CITIZEN REVIEW BOARDS EXIST BY VIRTUE OF STATE LAW OR JUDICIAL MANDATE AND USUALLY CONSIST OF FIVE TRAINED CITIZENS. CITIZEN REVIEW BOARDS EXAMINE PLANS AND RESULTS FOR EACH CHILD IN PLACEMENT. CITIZEN REVIEW BOARDS:

a. ACHIEVE HANDS ON ACCOUNTABILITY FOR EACH CHILD
b. GIVE CITIZENS RESPONSIBILITY FOR FELLOW CITIZENS
c. REMOVE VESTED INTEREST FROM FOSTER CARE DECISION MAKING
d. CREATE A WINDOW INTO AND OFFER ACCOUNTABILITY FOR THE WORKINGS OF TAXPAYER SUPPORTED PUBLIC SYSTEMS
e. EMPOWER KNOWLEDGEABLE CITIZENS TO WORK TOWARD IMPROVING THOSE SYSTEMS

TO EXPLAIN CITIZEN REVIEW I WILL USE MY OWN EXPERIENCE. AS A CITIZEN REVIEWER I WENT TO NEWARK NJ WEEKLY FOR OVER A DOZEN YEARS TO REVIEW CONFIDENTIAL RECORDS AND PLANS FOR CHILDREN AND TO TALK WITH CHILDREN, PARENTS, FOSTER PARENTS, AND CASEWORKERS. AFTER BEING TRAINED AND TAKING AN OATH OF CONFIDENTIALITY, MY FOUR FELLOW BOARD MEMBERS AND I BECAME A BOARD THAT REFLECTED THE SOCIO-ECONOMIC, CULTURAL, ETHNIC MAKE UP OF OUR COUNTY.

WE STUDIED THE CASEWORKER'S CONFIDENTIAL CASE FILE; PREVIOUS COURT RULINGS; CONFIDENTIAL PSYCHIATRIC, MEDICAL, AND POLICE REPORTS INCLUDING PICTURES OF BATTERED CHILDREN. WE EXPLAINED TO THE PARTIES IN EACH CASE THAT OUR JOB WAS ADVISORY, THAT OUR FOCUS WAS TO MOVE CHILDREN OUT OF FOSTER CARE AND INTO PERMANENT HOMES AS QUICKLY AS POSSIBLE AND THAT WE WERE VOLUNTEERS FROM THEIR COMMUNITY. AFTER TAKING TESTIMONY FROM ALL PARTIES, WE DISCUSSED, OFTEN DEBATED AND DEVELOPED RECOMMENDATIONS TO THE CASEWORKERS AND TO THE COURT. IT IS NOT ALWAYS EASY OR OBVIOUS TO DETERMINE THE MOST APPROPRIATE PLACEMENT PLAN FOR A CHILD.

MANY TIMES MY BOARD WAS ABLE TO REINFORCE A CASEWORKER WHO WAS GETTING NO COOPERATION FROM A RECALCITRANT PARENT OR NO ACCESS TO A JUDGE. MANY TIMES MY BOARD AMPLIFIED OR DISAGREED WITH THE AGENCY'S CASE PLAN. THIS DOES NOT MEAN THAT REVIEW BOARDS ALWAYS ASSUME AN ADVERSARIAL ROLE. OFTEN A CASEWORKER WOULD COME BEFORE US AND SAY "AGENCY POLICY REQUIRES THIS BUT I THINK SOMETHING ELSE WOULD BE BETTER FOR THAT CHILD SO PLEASE CONSIDER THAT AS YOU DEVELOP YOUR RECOMMENDATION".

OUR EXISTENCE AS A MONITORING PRESENCE ASSURED THAT CHILDREN IN OUR CASELOAD WOULD NOT END UP ON THE BOTTOM OF SOMEONE'S PILE OF CASES, NEVER TO SURFACE, THEREFORE NEVER TO BE SERVED, THEREFORE TO SPEND AN ENTIRE CHILDHOOD IN SUBSTITUTE CARE. OUR PERIODIC REVIEWS REVEALED PROGRESS OR LACK OF PROGRESS PARENTS WERE MAKING AND WHETHER CHILDREN COULD RETURN SAFELY HOME. TOO OFTEN NO ONE HAD MADE PROGRESS BECAUSE NO CASEWORKER WAS ASSIGNED. THAT USUALLY WAS DUE TO CASEWORKER TURNOVER OR CIVIL SERVICE AND BUDGETARY POLICIES. THE NECESSITY OF HAVING PERIODIC REVIEW IS DEMONSTRATED BY THE FREQUENCY WITH WHICH AGENCY WORK ON THE CASE PLAN DID NOT

BEGIN UNTIL LONG AFTER THE PLAN WAS MADE AND, COINCIDENTALLY, JUST BEFORE OUR PERIODIC REVIEW WAS SCHEDULED TO TAKE PLACE.

CITIZEN REVIEW OPENS A WINDOW TO ALL THOSE SERVICES, AGENCIES AND SYSTEMS THAT IMPACT ON A CHILD DEPENDENT ON THE STATE AS PARENT. WE HAVE LEARNED OF THE TREMENDOUS BURDEN OUR PROTECTIVE SERVICE SYSTEM PLACES ON CASEWORKERS AND OF CASEWORKERS' STRUGGLES TO HELP PEOPLE. AND WE HAVE LEARNED OF LITTLE THINGS--IRRITANTS THAT TAKE THEIR TOLL FINANCIALLY IF NOT EMOTIONALLY. IMAGINE BEING A PROTECTIVE SERVICE WORKER WALKING INTO A HOME AND, IN THE NAME OF SAFETY, TAKING A CHILD AWAY FROM THAT HOME OVER PROTESTATIONS OF PARENTS AND CHILD. WHEN YOU RETURN TO YOUR CAR WITH THE CHILD YOU FIND A PARKING TICKET ON YOUR CAR WHICH THE CITY WILL NOT FORGIVE. ADD INSULT TO INJURY AND ADD PARKING TICKETS TO THE AGENCY BUDGET. REVIEW BOARDS BEAMED QUITE A BIT OF LIGHT ON THAT PART OF THE BUDGET.

WE HAVE BEEN SHOCKED TO OBSERVE HOW OFTEN, IN SO MANY CASES, SERVICES AND AGENCIES FAIL CHILDREN AND FAMILIES. WE HAVE OBSERVED HOW SYSTEMS THAT ARE NOT WORKING FOR CHILDREN, TRAP CHILDREN IN THOSE SYSTEMS.

STATE CITIZEN ADVISORY BOARDS ARE ALSO A PART OF THE CITIZEN REVIEW SYSTEM. THE STATE BOARDS ELEVATE PRACTICAL KNOWLEDGE OF REVIEWERS AND DOCUMENTATION BY REVIEW BOARDS TO THE LEVEL OF RAISING QUESTIONS OF POLICY, PRACTICE AND PROCEDURE. STATE BOARDS ARE AN INDEPENDENT BODY MADE UP OF VOLUNTEERS, MOSTLY CITIZEN REVIEWERS, FROM JURISDICTIONS THROUGHOUT THE STATE. ADVISORY BOARDS GENERALLY ASK CITIZEN REVIEWERS TO DOCUMENT SYSTEMS BARRIERS IN EACH CASE THEY REVIEW. ADVISORY BOARDS MAKE RECOMMENDATIONS ANNUALLY TO THE LEGISLATURE, GOVERNOR AND SUPREME COURT OF THAT STATE. THEIR INDEPENDENCE ALLOWS THEM TO DIRECT RECOMMENDATIONS TO ANY PART OF THE SYSTEM.

A FEW EXAMPLES OF CITIZEN REVIEW AT WORK

CITIZENS CAN TELL YOU OF CHILDREN LIKE MARIA FOR WHOM THE AGENCY PLAN WAS RETURN TO HER FATHER--UNTIL SHE TOLD MY REVIEW BOARD THAT, FOR THE SECOND TIME, SHE WAS CARRYING HER FATHER'S CHILD. CITIZENS CAN TELL YOU OF FINDING RELATIVES THE AGENCY COULD NOT FIND OR DID NOT KNOW EXISTED. MY BOARD REVIEWED A FAMILY OF SIX CHILDREN WHO WERE SCATTERED IN FOUR DIFFERENT PLACEMENTS BECAUSE THEIR MOTHER WAS UNABLE TO PAY RENT. OUR INTERACTION WITH PARTIES WE INTERVIEWED RESULTED IN FINDING THE "LOST" FATHER WHO AGREED TO MAKE MONTHLY RENT PAYMENTS FOR HIS FAMILY OUT OF HIS LUCRATIVE TRUCK DRIVING JOB. THE STATE SAVED THE COST OF SIX FOSTER CARE PLACEMENTS.

CITIZENS CAN CITE MYRIADS OF CASE EXAMPLES DEMONSTRATING THAT ONE OF THE BIG PROBLEMS SOME CHILDREN FACE IS BUREAUCRATIC POLICIES WITHIN THE VERY SYSTEMS THAT ARE SUPPOSED TO BE HELPING CHILDREN...SYSTEMS SUPPORTED BY OUR OWN TAX DOLLARS.

BEFORE CITIZEN REVIEW CAME TO NEW JERSEY THE AGENCY WAS RESPONSIBLE FOR ABOUT 13,000 CHILDREN IN PLACEMENT. THEY WERE NOT SURE. THREE YEARS AFTER CITIZEN REVIEW, THE CASELOAD HAD DROPPED TO 6,500 DOCUMENTED CHILDREN. OTHER STATES ALSO REPORT DRAMATIC DROPS IN CASELOAD AFTER CITIZEN REVIEW BOARDS WERE INTRODUCED. THINK OF THE MONEY SAVED!

MARYLAND CITIZEN REVIEW BOARDS HAVE REVIEWED CHILDREN IN PLACEMENT FOR OVER FIFTEEN YEARS. 400 MARYLAND VOLUNTEER CITIZEN REVIEWERS ARE SUPPORTED BY 25 STAFF. MARYLAND CITIZEN REVIEWERS CONDUCTED NEARLY 11,000 REVIEWS OF

INDIVIDUAL FOSTER CHILDREN LAST YEAR. THERE IS A COST TO ADMINISTERING CITIZEN FOSTER CARE REVIEW--IN MARYLAND EACH REVIEW COSTS ABOUT EIGHTY DOLLARS ($80). IN JUXTAPOSITION TO THIS FIGURE IS THE FACT THAT THE AVERAGE ANNUAL COST IN MARYLAND OF KEEPING A CHILD IN FOSTER CARE IS $20,000. IF A CHILD IS REMOVED FROM THE SYSTEM ONE MONTH EARLIER BECAUSE OF REVIEW BOARD MONITORING, THE STATE SAVES ABOUT $1,400 IN THAT MONTH.

IOWA HAS DOCUMENTED THAT CHILDREN WITH REVIEW BOARDS WERE DISCHARGED FROM FOSTER FAMILY CARE 90 DAYS EARLIER AND FROM GROUP FOSTER CARE 29 DAYS EARLIER THAN THOSE WITHOUT REVIEW BOARDS. THESE ARE SAVINGS OF 1.5 AND 1.7 MILLION DOLLARS RESPECTIVELY. IOWA HAS ALSO DOCUMENTED THAT ADOPTION OF CHILDREN WITH REVIEW BOARDS WAS ACHIEVED 453 DAYS SOONER AT A PER CHILD COST SAVINGS OF $9,500 TO $34,000.

NATIONALLY, IN 1992, **3,500 VOLUNTEERS** REVIEWED CASE PLANS FOR OVER **50,000 CHILDREN** PLACED OUTSIDE OF THEIR HOMES. CURRENTLY NAFCR DOES NOT HAVE THE CAPACITY TO DOCUMENT THEIR SUCCESS STORIES ON A CASE BY CASE BASIS AND THEREFORE REPORT THE TOTAL DOLLAR SAVINGS. THE COST EFFECTIVENESS WOULD BE AMPLIFIED IF ONE WERE TO ASCRIBE A PER HOUR DOLLAR VALUE FOR EVERY HOUR OF VOLUNTEER TIME DONATED ON BEHALF OF CHILDREN.

KEEP THE PROTECTIONS, KEEP THE OVERSIGHT

CHILDREN IN PUBLIC SYSTEMS MUST BE PROTECTED. PL96:272 SPECIFIES SEVERAL PROTECTIONS THAT NOW APPLY TO BOTH TITLE IV-B AND IV-E PROGRAMS. THIS INCLUDES PERIODIC, INDEPENDENT MONITORING OF EVERY CHILD. THESE PROTECTIONS WERE ENUMERATED BECAUSE THEY WERE NOT BEING PRACTICED. THESE PROTECIONS MUST BE MAINTAINED AS PART OF BLOCK GRANTS. BLOCK GRANTS SHOULD MAINTAIN OVERSIGHT FOR ACCOUNTABILITY AND CONGRESS SHOULD HOLD STATES ACCOUNTABLE BY IMPOSING PENALTIES FOR FAILING TO MEET THE STANDARDS OF PROTECTION.

OUR EXPERIENCE AS CASE REVIEWERS HAS DEMONSTRATED THE IMPORTANCE OF REVIEWS IN GETTING TREATMENT FOR ABUSED AND NEGLECTED CHILDREN, PREPARING FAMILIES FOR THEIR CHILDREN'S RETURN, AND, WHERE APPROPRIATE, PUSHING AGENCIES TO FREE CHILDREN FOR ADOPTION. IT IS ESSENTIAL THAT THE CONGRESS HOLD STATES ACCOUNTABLE FOR PROVIDING THESE IMPORTANT PROTECTIONS FOR CHILDREN.

THE INTENT AND CLOUT OF THE 427s

SHOULD BE MAINTAINED
AND A LESS COSTLY REVIEW MECHANISM SHOULD BE IMPLEMENTED

THE COMMITTEE HEARING ANNOUNCEMENT IMPLIES THAT 427 REVIEWS "IMPOSE A COSTLY AND BURDENSOME WORKLOAD ON THE STATES". CERTAINLY THE REQUIREMENTS OF THOSE REVIEWS ARE PART OF GOOD CASE PRACTICE. TO REDUCE COSTS BY ELIMINATING GOOD CASE PRACTICE WILL IMPAIR THE QUALITY OF SERVICE PROVIDED BY THE AGENCY. CASELOADS WILL CLIMB--COSTS WILL ACCELERATE.

REVIEW REQUIREMENTS IMPOSED UPON THE COURTS HAVE HEIGHTENED THE REALIZATION OF JUDGES THAT THEIR DECISIONS MUST INTERACT WITH CASE PLANS AND CASE MANAGEMENT. THE COURT REQUIREMENTS

OF THE 427 REVIEWS ARE STRONG INCENTIVES FOR COMMUNICATION AND COORDIANTION ABOUT A CHILD BETWEEN CASEWORKERS AND JUDGES. HERE TOO THE REQUIREMENTS ENUMERATE LOGICAL PRACTICE AND SHOULD NOT BE PERCEIVED AS AN EXTRA COST IF THE GOAL IS TO DO THE BEST JOB POSSIBLE FOR THE CLIENT.

PERHAPS THE MOST FALLACIOUS ARGUMENT ABOUT COSTLINESS OF REQUIREMENTS UNDER 427 IS THE FACT THAT, IN MANY STATES THE INDEPENDENT REVIEW ASPECT IS CARRIED OUT COST EFFECTIVELY BY VOLUNTEERS. ALL STATES SHOULD ADOPT THIS MECHANISM AND FREE THEIR PAID AGENCY STAFF TO DO FIELD WORK INSTEAD OF CONDUCTING REVIEWS THAT ARE INTERNAL AND THEREFORE NOT REALLY INDEPENDENT. THE BEST PLAN FOR A CHILD MIGHT BE SACRIFICED TO AGENCY POLICY BY INTERNAL REVIEWERS WHO ARE BOUND BY THE POLICY.

AT THIS TIME ONLY HALF OUR STATES HAVE CITIZEN REVIEW. CONGRESSMAN CARDIN, OF THIS COMMITTEE, INTRODUCED REPORT LANGUAGE IN THE 1994 OMNIBUS BUDGET RECONCILLIATION ACT TO ENCOURAGE EXPANSION OF CITIZEN REVIEW. THE 1995 SENATE APPROPRIATIONS BILL ALSO URGES THE EXPANSION AND TRAINING OF CITIZEN REVIEWERS BY REQUESTING HHS TO ALLOCATE ONE MILLION DOLLARS ($1,000,000) TO NAFCR TO PROMOTE CITIZEN REVIEW AND TRAINING OF CITIZEN REVIEWERS.

THE NATIONAL ASSOCIATION OF FOSTER CARE REVIEWERS RECOMMENDS THAT CONGRESS EMBRACE THE CONCEPTS OF:

CITIZENS CARING FOR CITIZENS

AND

CITIZENS HOLDING THEIR TAX SUPPORTED PUBLIC SYSTEMS ACCOUNTABLE.

THE NATIONAL ASSOCIATION OF FOSTER CARE REVIEWERS RECOMMENDS THAT CONGRESS INCORPORATE IN ITS PROTECTIONS FOR CHILDREN AND FAMILIES, THE REQUIREMENT THAT A CITIZEN FOSTER CARE REVIEW BOARD REGULARLY, PERIODICALLY MONITOR EACH CHILD. AS LONG AS THAT CHILD IS IN THE PLACMENT SYSTEM.

IF THE POLICY OF BLOCKGRANTING IS TO BRING DECISION MAKING TO STATES, WHO IS BETTER ABLE THAN CITIZENS OF THE STATE TO HOLD THEIR OWN STATES ACCOUNTABLE? WHO CAN BETTER DOCUMENT THE REALITIES THAN VOLUNTEERS WITH ACCESS TO THE CONFIDENTIAL WORKINGS OF THEIR PUBLIC SYSTEMS? WHO CAN BETTER MONITOR THAN THOSE WITHOUT VESTED INTEREST. WHO CAN BETTER CALL FOR QUALITY AND ACCOUNTABILITY THAN DEDICATED VOLUNTEERS WHO DONATE THEIR TIME ON BEHALF OF CHILDREN BECAUSE THEY BELIEVE EVERY CHILD SHOULD GROW UP IN A SAFE, PERMANENT HOME?

CITIZEN REVIEW IS A PROVEN COST EFFECTIVE MECHANISM BASED 90% ON VOLUNTEER EFFORT.

CITIZEN REVIEW BRINGS OUT THE VOLUNTEER SPIRIT AND OFFERS THE COMMUNITY A WAY OF HELPING CHILDREN AND FAMILIES. CITIZEN REVIEW HAS DEMONSTRATED THAT THERE ARE LARGE NUMBERS OF PEOPLE WILLING AND CAPABLE OF VOLUNTEERING AS A REVIEWER.

IN THE LAST FIFTEEN YEARS, THE EXPERIENCE OF REVIEWERS REINFORCES THE NOTION THAT WE MUST OPEN MORE WINDOWS ONTO OUR PUBLIC SYSTEMS IF WE ARE TO KNOW HOW THEY ARE REALLY WORKING. BLOCK GRANTS OFFER AN OPPORTUNITY FOR CITIZENS TO BECOME INVOLVED WITH THEIR FELLOW CITIZENS, TO IDENTIFY WASTEFUL BUREAUCRATIC PRACTICES, TO IDENTIFY NEEDED COMMUNITY

SERVICES, TO OBSERVE THEIR TAX DOLLARS AT WORK AND TO PRESENT THEIR LEGISLATURES WITH UNBIASED FACTS.

WE RESPECTFULLY SUGGEST CITIZEN REVIEW SHOULD BE PROMOTED WHETHER TITLES IVB & E ARE BLOCK GRANTED OR NOT.

CITIZEN REVIEW AND THE ADOPTION SYSTEM

SOME EXAMPLES OF THE COST EFFECTIVENESS AND VALUE OF ONGOING CITIZEN REVIEW AS IT IMPACTS ON ADOPTION FOLLOW.

CITIZEN REVIEWERS HAVE LEARNED THAT IN STATE AFTER STATE THE ADOPTION SYSTEM IS OFTEN ILL--IT IS CONSTIPATED--THE CHILDREN GET STUCK.

- IN NEBRASKA, HOME OF THE PLACEMENT FACILITY BOYSTOWN, THREE SEPARATE STUDIES BY DR. ANN COYNE HAVE CONFIRMED THAT A CHILD IS TWICE AS LIKELY TO BE ADOPTED IF THE CHILD IS BEING MONITORED BY A CITIZEN REVIEW BOARD. THINK OF THE MONEY SAVED.

- ADOPTIONS REQUIRE COURT PROCEEDINGS. A STUDY OF THE EFFECT OF CITIZEN REVIEW BOARDS IN KANSAS INDICATED THAT CONTINUANCE OF CASES BY THE COURT WERE REDUCED BY TWO THIRDS WHEN THE CASES WERE SUBJECT OF A CITIZEN REVIEW. THINK OF THE MONEY SAVED.

- IN MARYLAND, AFTER CITIZEN REVIEWERS BEGAN TRACKING MILESTONES AND ADVOCATING SYSTEMATICALLY, THE NUMBER OF CHILDREN ADOPTED ROSE 50% AND ADOPTION DELAYS FELL 29%. THINK OF THE MONEY SAVED.

427 REVIEWS, ACCOUNTABILITY AND SANCTIONS

WE URGE YOU TO INCORPORATE IN BLOCK GRANT PHILOSOPHY ACCOUNTABILITY FOR RESULTS IN EACH STATE. THE GRANTS THEMSELVES SHOULD HAVE CLEARLY DEFINED, HIGH STANDARDS AND EXPECTATIONS ALONG WITH A SCHEDULE OF DOLLAR PENALTIES AND/OR REWARDS. CONGRESS SHOULD REQUIRE STATES TO ESTABLISH THE MONITORING MECHANISM OF CITIZEN REVIEW THAT WILL DOCUMENT ADHERENCE TO THE STANDARDS. WITHOUT SUCH AN ACCOUNTABILITY MECHANISM, HOW WILL STATE LEGISLATURES OR CONGRESS KNOW WHAT THEY ARE GETTING FOR THEIR BLOCK GRANTED DOLLARS.

AGENCIES RESPOND TO FISCAL SANCTIONS. REVIEW BOARDS OBSERVED THAT THE POSSIBILITY OF SANCTIONS WAS EXTREMELY EFFECTIVE IN FORCING STATES TO PAY ATTENTION TO THEIR FOSTER CARE CASELOAD--BECAUSE TITLE IVB AND IVE DOLLARS WERE AT STAKE.

FEDERAL 427 REVIEWS WERE POORLY CARRIED OUT AND DID NOT RELATE TO QUALITY. THIS IS NOT A CONDEMNATION OF THE DEDICATED STAFF IN THE CHILDREN'S BUREAU WHO ARE SKILLED PROFESSIONALS STRETCHED FAR TOO THIN. THEY DID WHAT THEY COULD.

DESPITE THE INADEQUACY OF THE 427 REVIEWS--

- IT WAS REMARKABLE HOW STATES TOOK NOTICE OF THEIR FOSTER CARE CASELOADS WHEN THEIR ACTIONS WERE SUBJECT TO SCRUTINY AND THEIR DOLLARS WERE ON THE LINE.

- IT WAS WONDERFUL TO OBESERVE THE EFFECT OF 427 MONITORING IN ENLIGHTENING COURTS ABOUT THEIR RESPONSIBILITES TO THE FOSTER CARE POPULATION

BUT 427 REVIEWS WERE TOO FAR REMOVED FROM CHILDREN TO REQUIRE ACCOUNTABILITY FOR CARRYING OUT THE PROTECTIONS OF THE LAW FOR THAT CHILD. BRINGING DECISION MAKING CLOSER TO HOME MEANS WE MUST BRING MONITORING AND ACCOUNTABILITY CLOSER TO HOME. CONGRESS MUST MAINTAIN THE ABILITY TO IMPOSE SANCTIONS BASED, AT LEAST IN PART, ON DOCUMENTATION RESULTING FROM HANDS ON MONITORING.

WE URGE THE CONGRESS TO:

- CONTINUE TO PROTECT CHILDREN BY REQUIRING CASE BY CASE REVIEWS.

- REQUIRE STATES TO PUT IN PLACE A STRONG, INDEPENDENT, COST EFFECTIVE MONITORING MECHANISM USING TRAINED VOLUNTEERS.

- BLOCK GRANT SUPPORT FOR THAT MONITORING MECHANISM DIRECTLY, TO ASSURE ITS INDEPENDENCE.

- REQUIRE STATE CITIZEN ADVISORY BOARDS TO REPORT ANNUALLY THEIR DATA AND RECOMMENDATIONS TO THE LEGISLATURE, SUPREME COURT, AND GOVERNOR.

- UTILIZE CITIZEN REVIEW DATA AS AN ASSISTANCE AT THE FEDERAL LEVEL TO REQUIRE COMPLIANCE WITH THE PROTECTIONS OF THE LAW THROUGH FISCAL PENALTIES AND/OR INCENTIVES.

FUNDING THE ACCOUNTABILITY MECHANISM OF CITIZEN REVIEW

NAFCR RECOMMENDS BUILDING IN THE ACCOUNTABILITY MECHANISM OF CITIZEN REVIEW AS A COMPANION TO BLOCK GRANTS. IN ORDER TO ASSURE COMPLETE INDEPENDENCE, FUNDING TO SUPPORT CITIZEN REVIEW SHOULD BE BLOCKED DIRECTLY TO THE STATE CITIZEN REVIEW BOARD.

VOLUNTEERS DONATE TIME AND ENERGY AND ARE COST EFFECTIVE BUT, MONITORING BY VOLUNTEERS, OR ANYONE ELSE, WILL BE A SHAM WITHOUT AN INFRASTRUCTURE OF TRAINING, DATA GATHERING ABILITY AND SUPPORT STAFF.

STATE CITIZEN REVIEW BUDGETS ARE LOW. CURRENTLY NO STATE CITIZEN REVIEW PROGRAM HAS A BUDGET EVEN AS HIGH AS $2,000,000 (TWO MILLION DOLLARS).

INCLUDED IN GRANTS TO STATE CITIZEN REVIEW BOARDS WOULD BE THE COSTS OF ESTABLISHING AND MAINTAINING THE DATA COLLECTION ASPECT UPON WHICH ANNUAL REPORTS WOULD BE BASED AND WHICH WILL PROVIDE INFORMATION REQUESTED FOR FEDERAL OVERSIGHT.

THE NATIONAL ASSOCIATION OF FOSTER CARE REVIEWERS WOULD WORK WITH CONGRESS AND HHS IN DETERMINING WHAT DATA REVIEWERS SHOULD DOCUMENT. NAFCR WOULD BE RESPONSIBILE FOR EXCELLENT VOLUNTEER TRAINING TO ASSURE QUALITY OF CITIZEN REVIEW. IT WOULD BE RESPONSIBLE FOR ONGOING AND REMEDIAL TRAINING AND PROVIDE DATA COLLECTION EXPERTISE THAT WILL HELP STATES ASSURE ADHERENCE TO FEDERAL STANDARDS AND PROTECTIONS. IN ORDER TO MAINTAIN AND REINFORCE THE INDEPENDENCE OF CITIZEN REVIEW FROM OTHER GOVERNMENTAL ENTITIES, FUNDING FOR CARRYING OUT THESE RESPONSIBILITIES WOULD BE GRANTED DIRECTLY TO NAFCR.

WELL TRAINED VOLUNTEERS WHO ARE EMPOWERED BY LAW TO FOCUS ON THE BEST INTEREST OF EACH INDIVIDUAL CHILD AND TO HOLD PUBLIC SYSTEMS ACCOUNTABLE BY COMPILING DATA ON A CASE BY CASE BASIS WILL SAVE STATES UNTOLD NUMBERS OF DOLLARS. THE COST OF SUPPORTING THE VOLUNTEER EFFORT WILL BE MINIMAL IN RELATION TO ITS REWARDS OF SAVING PUBLIC DOLLARS AND SAVING CHILDREN FROM GROWING UP AS A WARD OF THE STATE.

THE NATIONAL ASSOCIATION OF FOSTER CARE REVIEWERS URGES ADOPTION OF THE CONCEPT OF CITIZEN REVIEW FOR ALL CHILDREN IN PLACEMENT.

Chairman JOHNSON. Thank you very much, Ms. Driver.

Mr. Cooper.

Mr. COOPER. Of course, we endorse what she said. I am the director of the Maryland Citizen Foster Care Review Board office. We have about 400 volunteers. I would like to make the point in conducting these 11,000 reviews, we make a lot of—we make a lot of difference in the compliance of the agency with the 427 review process, so it is important to us. It gives us the handle we need to have citizens get in there and hold people accountable, and we have results. For example, like Mr. Petit talked about, the reentry rate is 50 percent of the children returned home are back in the system in about 1 year.

Mr. PETIT. Forty.

Mr. COOPER. In Maryland, that is about 16 percent. So we believe we—our review system and other things our State has done has brought more quality to the system than you have when you have merely internal reviews of an agency reviewing itself.

We are involved in system advocacy that addresses what Mr. Henry talked about. For example, our citizen reviewers are supporting and initiating bills in this year's legislature to make sure fathers are identified and contacted and that relatives are brought into the process appropriately. So I think that citizen review really provides some assurance of the quality that the lady from New Jersey, Ms. Barr, talked about. And someone came here from Illinois and talked where they have caseloads, I understand, of 100 children per worker and talked about the disasters of the program. The question is, is it in the program design or is it in some of the quality components that are missing from a State that doesn't have this kind of citizen accountability.

Chairman JOHNSON. Thank you.

I thank the panel for your good input. These citizen review boards, are they required or permitted by 427 reviews or is the 427 law silent on them?

Ms. DRIVER. The establishment of citizen foster care review boards across the country were encouraged by 427s, however, as was mentioned earlier, New Jersey, for example, and Arizona and South Carolina and some other States actually had citizen review before Public Law 96–272 came into being. However, it was a major impetus.

Chairman JOHNSON. Have they spread, then, since 427?

Ms. DRIVER. They have. And about four to five States within the last 2 years, are either adopting it completely or piloting it. But I think that in fact only about half the States currently actually use citizen foster care review boards. And of those that do use them, in every State not every child is reviewed.

Usually, in answer to your question about what creates them, usually it is State law. But otherwise, it is judicial mandates, because citizen review programs sometimes are postured within the courts, sometimes are independent and are postured different places in the system.

Chairman JOHNSON. Thank you very much.

I appreciate that clarification.

Mr. Matsui, would you like to inquire?

Mr. MATSUI. I will be very brief, Madam Chairwoman. I want to thank all six of you for being here today. I appreciate it very much.

One of the problems—and I wish Mr. Murphy was here because I am going to refer to him, not in a negative way, but just refer to him. One of our problems as we discuss the safety net, that is, the child welfare programs, when you get in a trap, you then bring up the overall problem with welfare itself and it is hard to defend the status quo, what is going on in many of the cities.

It is very, very difficult to talk about this issue in a very rational fashion, unfortunately. But I would like to confine my remarks basically to the child welfare system itself because that is the purpose of this discussion, whether we block grant it or make changes or make major, minor adjustments is what we are really talking about here. Perhaps, I will start with Mr. Petit.

You were up in Maine, if I am not mistaken?

Mr. PETIT. Yes, I was.

Mr. MATSUI. We talked, I think, it was in the 1987—1988, during consideration of the Family Support Act. How well are these programs—and you will have to forgive me. I was at another meeting and you may have addressed this. How well are these programs actually working? We are basically talking about foster care, obviously, adoption services, we are talking about family preservation. Obviously, the court system has to play a significant role in all of this. There is a mix of State-Federal money, State-Federal regulations. How are these programs really working? And can we make minor adjustments to make them work better?

Mr. PETIT. Well, in the first instance, child protection, the actual intake and assessment process within these agencies, I—you were absent, sir. What I stated was overall I give the system a "D" at best. There are literally hundreds of thousands of children known to the system right now who are at home with perpetrators who will be injured today, they will be raped today, and the system will have a very weak ability to intervene in those kinds of situations.

In many places, people are doing very good work. But on balance, it is a dangerous place for these kids. I cited one particular example of 9-year-old children in jails because they have been sexually abused because there is no place to put them.

In Sacramento County, your own county, and the agency there is a terrific agency, we are working with them right now. But because of what has happened in the State of California financially in the last few years, 24,000 cases of child protection are screened out over the telephone. In some—6,000 are actually investigated. We find workers who are inexperienced.

In some child protective units, 70 percent of the workers turn over in the course of a year. We held an administrative orientation for new child welfare directors and State commissioners between 1991 and 1993. We did one in both of those years. There has been a 70-percent turnover in one or both of those top two positions in child welfare nationally.

There are no standards that the States are being held to. There are an abundance of standards but they are not mandatory. So in some I think the situation—there is a wild variation in how it is conducted including within individual States.

We have reviewed thousands of records. We have talked with thousands of individual workers. What we find is a lack of purposefulness and focus among individual workers. They are frequently freelancing their work.

We would strongly recommend the adoption of standards that you condition Federal financing upon those standards and that you further require from each one of the States how much it would cost to come into compliance with those standards. In Texas right now, the child welfare expenditures are $350 million a year. They have some 10,000 or 15,000 kids in out-of-home care.

In Illinois, with one half the population, their child welfare expenditure is $1 billion with 50,000 children in out-of-home care. So while everyone has been reminded of how different the States are and the need to accord them great flexibility, the fact of the matter is the needs of children are strikingly similar from one jurisdiction to the next. And what we are seeing is by accident of geography, in many instances, you are protected or not.

Some States have zero children a year who are killed. Some States have 150 to 200 children a year that are killed. You can see it as a function of the kind of training that workers receive, how closely integrated the different systems are with each other. In California, again, because we are doing a lot of work there, in San Diego recently, their legal expenditures—and you raised earlier the question of paperwork, the legal expenditures in which children who are accorded attorneys, was $11 million a year on a $100-million-a-year budget.

The next largest jurisdiction we have been able to find was $1.8 million in Philadelphia, which happens to be the home of the Constitution where they also are concerned about due process kinds of considerations. So you have large numbers of people who are intervening in these cases who are not really laying their hands on children.

You know, one of the case plans that you alluded to before in terms of the workers not recording them, in San Diego County recently we ran into a situation where a mother was told the only way she can get her three children back, is if she visits them once a week, she gets a job, and if she curbs her substance abuse.

She curbed her substance abuse, she got a job. On Saturdays was the day that she tried to see her kids because she was working. All she had was public transportation. She couldn't travel the entire distance because the kids were in three different homes. It was taking her 8 to 10 hours a day just to get to where the children were. Because she was not able to visit them consistently, the children were denied from returning to her. A $2,000 or $3,000 investment in an automobile would have permitted this woman to take over responsibility for her family.

So I think, on balance, our view is that the situation is chaotic. Large numbers of children are being unnecessarily killed, raped and injured. We have seen this in every single State. There is not a single State in the country that we would hold up as a model. Certainly, some do a better job than others. And that is reflective of the investment.

The other thing I would tell you is that we have been involved with Ms. Lowry's organization, the ACLU, of which I am a card-

carrying member, and we have gotten deeply and intimately involved with the States in crafting a response to those legal actions. One of the things that we have discovered in doing that is that a frequent and recurring attitude among locally elected officials and Governors and State legislators around child welfare budgets is, don't ask and don't tell. They literally do not want to know.

They start out with a 95-percent funding request or 103-percent funding request, but they do not want to target it to what the States's administrators are specifically identifying as the need. So that simply returns to the point that there must be a strong Federal role in this process that accords maximum flexibility, that is a partnership kind of a function. And one of our last recommendations, and then I will cease on this one, is that you consider creating a fast-forward national panel comprised of some of the people that were here with strong representation of the States and local governments to work with you and your staffs to craft something very quickly in dealing with this issue.

The full dimensions of this problem have yet to be defined. We estimate that there are between 0.5 and 1 million children a year who are being sexually abused in this country and the overall response to that is a very, very weak one.

Mr. MATSUI. Anybody have any comments?

Ms. LOWRY. Yes, if I might. In response to the question that you started off with, Mr. Matsui, if the Federal statutes were being enforced, truly, we would see very different things happening in the States.

I agree with Mr. Petit about his description of the problems. But the general framework is in the statute now. It could be more specific, as I said in my testimony. But the statute already covers a broad range of issues which, if implemented, would protect children. And I think that is the real shame.

We could get a better one, but we haven't even enforced the one we have got. And that is my concern about giving up on what we have and going to something less. Not that things can't be improved. They always can. But if we were protecting children in the Federal child cap—I am sorry, the child abuse statute already requires not specifics, but that States have systems that will protect kids who are reported for child abuse and plans that are supposed to assure permanence. If we were doing that in the States, if anybody were ensuring that the States were doing these things, I think that we would have very different kinds of statements to make today.

Mr. MATSUI. And I didn't mean to interrupt because I know others—I will be very—I think Mr. Cooper has a comment. See, that is what is a little troubling with respect to the last panel, is the fact that these abusers and these murderers, that the gentleman from Michigan—or Illinois talked about, you know, there is no law—there are laws to make sure that doesn't happen.

Maybe—maybe Dr. Berger wants to comment on that, because I want a dialog here. I want to find out what the problem is. But it seems to me an issue—obviously, the system is overwhelmed. The system is overwhelmed and I see the frustration. But I would imagine there are laws for early intervention in those situations that, obviously, wasn't done in the Illinois case.

Ms. LOWRY. There really is no accountability. There are laws. States have very specific statutes and then the Federal Government has general statutes, but nobody is really following it. And as flawed as the 427 audits were, and they were, they at least at the beginning exercised some check that the States thought might come down on them. Then as the audits went forward and it became clear that they were not rigorous at all, then I think they came to have less weight. But I think if there was a clear message to the States, here are the basic minimal standards, you have got to follow them or something bad will happen, and we very much support the fact that Congress changed the sanctions so that there could be constructive intervention into the State other than simply a bang funding cutoff, then I think you might see something different in the States.

Mr. MATSUI. Can I have—Dr. Berger. Yes.

Ms. BERGER. Yes. I would just like to make a comment of caution on this. There is also a wave around this country which could only be described, the abuse of child abuse.

Mr. MATSUI. What was that?

Ms. BERGER. The abuse of child abuse. In other words, we are using child abuse disproportionately to try to put Federal regulation requirements in place. We have laws in existence that punish, and punish severely, people who abuse children: Parents, mothers and especially the boyfriends of single mothers, the live-in men in the households. Such laws are already in place. I do not know what system you want to develop whereby we have even more monitoring systems to develop, and costly, in addition. I furthermore do not see what the difference is between State laws and Federal laws. From my point of view, the rule of thumb is: The closer to the bottom of society, the closer to the problem, the better you have a chance of changing and improving the situation.

Mr. MATSUI. Let me ask you, though, you don't want the current criminal justice system to be the only one responsible, though, for the issue of child abuse, do you?

Ms. BERGER. I think this is your first line of defense and we all rely upon this. The second line of defense would be to develop general rules. But I do not see how you can have a Federal system of rules that can be implemented and that works.

Mr. MATSUI. But, Dr. Berger, here is what the problem is, though. I was on the city council 16 years ago. I was on there for 7, not quite 8 years. So, I mean, even then, we had problems in terms of our ability to really, you know, give adequate protection to our citizens. This was back in the early seventies, midseventies. And the system is totally overwhelmed now.

If you get a call to the police department under 911, you know, they are going to go to the armed robbery first. They are going to go to a violent crime, but domestic violence is still not high on the priority list in terms of the average local police department. I can just tell you, so you can't rely upon that to make the case.

Ms. BERGER. I would advise everyone to sit in courts and listen to cases whereby children are taken away from their families. Very often the rules of child abuse are very vague and at times even very hazardous. Let me give you an example; if you don't provide a regular breakfast, a warm breakfast to your children—you abuse

a child. The Federal stipulations are so ordinarily chaotic that you no longer know what is abuse or what is not abuse.

Chairman JOHNSON. We must go on to the others and then we can come back, if you would like to.

Mr. Johnson.

Mr. JOHNSON OF TEXAS. You sure?

Chairman JOHNSON. Yes. Because you have been here throughout the testimony.

Mr. JOHNSON OF TEXAS. OK. Thank you.

I agree with you, Doctor. I think it is impossible for the Federal Government to make its will known in the States. It is also improper for us to regulate it that closely. And as a matter of fact, this last election showed that people don't want more regulation, they want less.

I know in Texas, for example, the State courts do handle these systems and there are those who slip through the cracks in any system. And I think that if a parent is abusing a child, he is going to get punished for it under our current laws. You are absolutely right in saying it is better conducted closer to home. And I thank you for that comment.

Would you like to respond?

Ms. BERGER. May I just make another comment which occurred to me all through this morning. Everyone talks about the single importance of highly trained and credentialed child care workers. I know one case Ms. Lowry has been involved in. A residential school for disabled children—the single best person dealing with these children was a Polish peasant with 6 years of education. This person would no longer be employed because of the new Federal laws that require credentials.

In other words, we are depriving ourselves of good people to care for clients like the ones you are representing. There are many good people in every uncredentialed community. So if you write out new kinds of stipulations, I would like them to be much more flexible and not apply to credentialing. No amount of education can make you into a good child care worker, and I know a lot about this because I have done reviews at residential homes for abused children. So I am—I am sorry, Mr. Matsui, that I come to that conclusion. When I started out 30 years ago to work on such issues, I was on your line, as well. It has been a bitter experience and I had to rethink many issues.

Mr. PETIT. I think that the issue is not intervening in those kinds of situations. The problem is the State right now has magnum force in intervening in the lives of people and, in many instances, you don't need the police and you certainly don't need child protective services. Many of the garden variety kinds of neglect cases could be handled well by public health nurses, by community and socialworkers, and so forth.

What is missing right now across the country is an assessment process that allows a good analysis of what is going on within a household, being done by mature workers that allows them to select from a menu of services and says this is what we would like to plug this family into. The great majority of these cases don't need State intervention, what they need is local community intervention of a nonminimally intrusive kind of a nature.

The problem right now is that the States, most of them, because they are so strapped for cash, and especially locally, is that they have a triage system. They are going out on only the most severe cases. I know of virtually no system that has the luxury of removing children from their families because of something like improper meals. Forget warm meals. Even if they are not doing meals, in many instances, they will not intervene in those kinds of cases. The States are not all equal on this.

I would just note, Mr. Johnson, in Texas, with all due respect, there are more than 100 children a year who are killed in Texas every single year. It is not one of the stronger systems that exists nationally. And you know, there is no basis for the Federal Government at this point interjecting itself into those situations at a protective level.

Mr. JOHNSON OF TEXAS. But your statement, Mr. Petit, that there is over 100 in Texas killed, from what cause?

Mr. PETIT. From—at the hands of parents, at the hands of family members.

Mr. JOHNSON OF TEXAS. You know, I won't believe that unless you show me the precise cases.

Mr. PETIT. I would be very happy to show you the cases.

[The following was subsequently received:]

Child Welfare League of America, Inc.
440 First Street NW Suite 310 Washington DC 20001-2085 • 202/638-2952 • FAX 202 638-4004

February 6, 1995

The Honorable Sam Johnson
1030 Rayburn House Office Building
U. S. House of Representatives
Washington, DC 20515

Dear Representative Johnson:

This letter follows up on the brief discussion we had at the Ways and Means Oversight Subcommittee hearing on January 23, 1995 on Title IV-E and the 427 review process. During my report on the problems associated with unevenness of arrangements, responses and resources within and among the states, I described data on child fatalities nationally and in several states, including Texas. You requested those data and I have enclosed the most recent information based on the 1993 survey by the National Committee to Prevent Child Abuse. Texas had 114 child abuse and neglect related fatalities in 1993. The data for 1994 will be available in April 1995.

I would be happy to discuss further with you these and other issues related to the state/federal partnership to protect abused and neglected children.

Sincerely,

Michael Petit
Deputy Director

Enclosure

cc: Chairwoman Nancy Johnson

Current Trends in Child Abuse Reporting and Fatalities:

The Results of the 1993 Annual Fifty State Survey

Karen McCurdy, M.A., Principal Analyst
Deborah Daro, D.S.W., Director

Prepared by:

The National Center on Child Abuse Prevention Research,
a program of
The National Committee to Prevent Child Abuse

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National Committee to Prevent Child Abuse (NCPCA)
332 S. Michigan Ave., Suite 1600
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Other NCPCA Publications
NCPCA publishes a variety of educational materials that deal with parenting, child abuse, and child abuse prevention. For a free catalog, contact NCPCA Fulfillment Center, (800)835-2671.

Table 3

CHILD ABUSE AND NEGLECT RELATED FATALITIES

State	1985	1990	1991	1992	1993
Alabama	NA	14	17	21	25
Alaska	NA	0	2	0	NA
Arizona	NA	14	12	13	24
Arkansas**	9	9	9	17	9
California	18	78	100	90L	NA
Colorado	12	31	32	34P	28P
Connecticut	6	17	5	10	16
Delaware	2	1	3	14	NA
Dist. of Columbia	NA	NA	5	11P	13P
Florida	NA	72	60	67	63
Georgia*	NA	12	13	10	12
Hawaii	1	2	5	3	0
Idaho	5	4	6	3	6
Illinois	53	75	92	77P	76P
Indiana	29	54	51	49	38
Iowa	9	9	15	10	6P
Kansas	16	11	4	6	6
Kentucky	10	20	17	24	20
Louisiana	50	28	36	23	25P
Maine	0	6	6	5	7
Maryland	8	16	38	31	29
Massachusetts	13	16	9	15	NA
Michigan**	11	NA	15	19	NA
Minnesota	6	14	13	6	NA
Mississippi	NA	12	24	13	15P
Missouri	25	26	31	46	43
Montana	2	7	8	5	0
Nebraska	2	2	4	2	4
Nevada	6	1	7	4	8
New Hampshire	NA	NA	NA	NA	NA
New Jersey**	21	38	19P	19P	26P
New Mexico	10	8	6	4	6
New York	63P	105P	109P	78P	NA
North Carolina **	4	30R	13	24	NA
North Dakota	0	0	0	0	2

State	1985	1990	1991	1992	1993
Ohio	NA	NA	NA	41	46P
Oklahoma	16	18	38	20	23
Oregon	8	14	16	32	11
Pennsylvania	34	58	60	51	NA
Rhode Island	5	4	8	7	7
South Carolina	21	21	21	28P	NA
South Dakota	4	2	1	2	5
Tennessee*	NA	NA	NA	NA	15
Texas	113	112	97	103	114
Utah*	8	6	12	17	NA
Vermont	1	0	5	3	NA
Virginia	14	28	34	32	43
Washington	27	8	12	12	9
West Virginia	NA	1	3	2	5
Wisconsin	10	17	17	14	NA
Wyoming	3	4	4	6	1
Total Fatalities	655	1025	1114	1123	786
% of Child Population Under 18	80.7	93.3	93.2	97.7	60.5
Total Projected Fatalities Nationwide	812	1099	1195	1149	1299
Per 100,000 Children	1.3	1.72	1.86	1.76	1.96
% Change 1985 - 1993	-----50%------				
% Change 1990-1993	-----14%------				

L California's Dept. of Justice confirmed 69 deaths, LA county confirmed an additional 21 deaths.

P Not final #'s as some cases are still pending. For example, New York has 26 deaths still under review for 1992.

NA Not Available

R Reported Fatalities only

* These states only provide information on deaths due to abuse.

** Fatality information came from Death Review liaison.

TABLE 5–1.—NUMBER OF AGED AND DISABLED ELIGIBLE ENROLLEES AND BENEFICIARIES, AND AVERAGE AND TOTAL MEDICARE BENEFIT PAYMENTS

[Persons in thousands]

	Fiscal year										Projected average annual growth (percent)		
	1975 (actual)	1980 (actual)	1985 (actual)	1990 (actual)	1991 (actual)	1992 (actual)	1993 [1] (estimate)	1994 [1] (estimate)	1995 [1] (estimate)	1996 [1] (estimate)	1975–85	1985–90	1990–96
Part A:													
Persons enrolled (monthly) average):													
Aged	21,795	24,571	27,123	29,801	30,456	30,808	31,630	32,054	32,432	32,763	2.2	1.9	1.6
Disabled	2,047	2,968	2,944	3,270	3,380	3,561	3,833	4,094	4,389	4,683	3.7	2.1	6.2
Total	23,842	27,539	30,067	33,071	33,836	34,369	35,463	36,148	36,821	37,446	2.3	1.9	2.1
Beneficiaries receiving reimbursed services:													
Aged	4,906	5,943	6,168	6,070	6,110	6,710	6,820	6,960	7,100	7,230	2.3	−0.3	3.0
Disabled	456	721	672	680	700	735	805	865	935	1,000	4.0	0.2	6.6
Total	5,362	6,664	6,840	6,750	6,810	7,445	7,625	7,825	8,035	8,230	2.5	−0.3	3.4
Average annual benefit per person enrolled: [2 3]													
Aged	$326	$853	$1,563	$1,971	$2,007	$2,324	$2,539	$2,800	$3,009	$3,260	17.0	4.7	8.7
Disabled	$345	$948	$1,806	$2,139	$2,177	$2,527	$2,665	$2,861	$3,024	$3,232	18.0	3.4	7.1
Total	$327	$863	$1,587	$1,987	$2,024	$2,345	$2,553	$2,807	$3,010	$3,257	17.1	4.6	8.6
Part B:													
Persons enrolled (average):													
Aged	21,504	24,422	27,049	29,426	29,910	30,471	30,982	31,354	31,697	32,000	2.3	1.7	1.4
Disabled	1,835	2,698	2,672	2,907	3,023	3,163	3,383	3,656	3,954	4,244	3.0	1.7	6.5
Total	23,339	27,120	29,721	32,333	32,933	33,634	34,365	35,010	35,651	36,244	2.4	1.7	1.9
Beneficiaries receiving reimbursed services:													
Aged	11,311	16,034	20,199	23,820	24,115	25,603	25,994	26,682	27,355	27,968	6.0	3.4	2.7
Disabled	797	1,669	1,933	2,184	2,276	2,522	2,772	3,031	3,326	3,620	9.3	2.5	8.8
Total	12,108	17,703	22,132	26,004	26,391	28,125	28,766	29,713	30,681	31,588	6.2	3.3	3.3
Average annual benefit per person enrolled: [2]													
Aged	$153	$347	$705	$1,250	$1,342	$1,403	$1,474	$1,593	$1,781	$1,957	16.5	12.1	7.8
Disabled	$259	$615	$1,021	$1,602	$1,758	$1,847	$1,994	$1,863	$2,005	$2,181	14.7	9.4	5.3
Total	$161	$374	$733	$1,282	$1,380	$1,445	$1,525	$1,621	$1,806	$1,983	16.3	11.8	7.5

[1] Represents current law. Does not include regulations or legislative proposals.

[2] Does not include administrative cost.

[3] Includes Part A catastrophic benefits beginning in fiscal year 1989. There are no catastrophic benefits after fiscal year 1990.

Source: Health Care Financing Administration, Division of Budget.

Mr. JOHNSON OF TEXAS. But in spite of that, what are they across the Nation?

Mr. PETIT. Texas has one of the highest rates.

Mr. JOHNSON OF TEXAS. What is the total?

Mr. PETIT. Right now, about 1,300 cases minimally believed, but in truth, the number is probably closer to 5,000. They frequently get put down to something else.

Mr. JOHNSON OF TEXAS. Actual fact, you are saying 1,300 a year?

Mr. PETIT. Inflicted. If the mother is on a fifth story of a building and she lets a 1-year-old child go out and play in traffic, does that constitute a child abuse death? No. It would not be so counted presently. It would just simply be a motor vehicular accident. But in the actual hands of the parents on the child, about 1,300 a year.

Mr. JOHNSON OF TEXAS. That is not child abuse in my view, either. That is mismanagement. That is the parent not taking responsibility of her kid but it is not abuse.

Mr. PETIT. It is a seriously neglectful situation that resulted in the child's death and it is exactly the kind of thing the State right now——

Mr. JOHNSON OF TEXAS. So you are saying the United States should get involved in that and control that person's life and tell each parent when and where they can let their children play, where and when they can let them ride a bicycle, where and when they can cross the street?

Mr. PETIT. If parents are endangering the lives of their children, since children are completely powerless and completely dependent upon their parents for protecting them, somebody has to intervene. That is why the states have created those child abuse laws.

Mr. JOHNSON OF TEXAS. You are absolutely wrong.

Mr. PETIT. What I am saying to you is that the child abuse laws as administered by the States vary widely, and in some States, they vigorously protect these children, and in other States, they don't protect these children and that is why so many kids are dying.

Mr. JOHNSON OF TEXAS. Where in our Constitution does it say the U.S. Government has the responsibility to take care of those kinds of situations?

Mr. PETIT. Life——

Mr. JOHNSON OF TEXAS. We are a States-rights constitution, believe it or not, and that is what we are getting back to, trying to.

Mr. PETIT. I think the Declaration begins with life, liberty and the protection of happiness.

Mr. JOHNSON OF TEXAS. It does not say protection, the pursuit of happiness, is the quote.

Mr. PETIT. Pursuit of happiness. I would say life is the first one. These kids are dying because nobody is intervening on their behalf, even though they are at-risk of being killed. If that isn't going to be intervened by government, who else is going to do it?

Mr. JOHNSON OF TEXAS. I am just going to say that I do not agree with that statement, and would close my questioning at that point.

Chairman JOHNSON. Thank you.

Mr. HERGER. Madam Chairman, if I could take 1 second to synthesize that, if I could please?

Chairman JOHNSON. Very briefly. We do have to adjourn at 2:30 and we have two more questioners.

Mr. HERGER. Madam Chair, the comments from both the panel and from the members of the committee have asked what ought to be the lines of defense, how do we get protection for children. We submit, at the Children's Rights Council, that the first line of defense for children is the family. We need to look at policies that the Federal Government has that get in the way of families doing their functions, policies that interfere with the things that families know how to do, policies that prevent families from being the best protection for children they can be.

Take, for example, the simple issue of paternity establishment. Every child in this country is born with, wants, loves, and needs two parents. We have a system right now under which the greater number of our welfare recipients don't even know who their dad is, and find that their dad is actively concealed from them by a welfare system that doesn't care about that dad, except to see him as a nuisance.

Just to give you an example of one case we publicized a bit during this summer, not that it is any different from many other cases, but simply one we picked out. A man and a woman with low income had a baby out of wedlock and decided to do the right thing. Got married, moved in together, kept their minimum-wage jobs. What was the response of the bureaucracy? What did they say as soon as they found those people? They said: "Dad, you must leave. You are hurting your child by being here."

If we care about children in this country, we have got to adopt that physician's law, "first, do no harm." Get government out of the business of damaging families and then see what we can do to help families as a second step.

Chairman JOHNSON. Mr. Hancock.

Mr. HANCOCK. I was just thinking about this conversation between Sam and Mr. Petit. Evidently, I am a child abuser, because there have been times when I didn't have my eye on my child 24 hours a day. I can think of a case where a small child recently got run over as a result of a car being left out of gear and the little child was out in the driveway.

I know the family real well, but they were not guilty of any form of child abuse whatsoever. So I take offense to the extent that that was carried. And I agree with Mr. Johnson, that this is not a function of the Federal Government.

Wasn't the reason that we are holding this hearing to decide whether we should have block grants and to get the Federal Government out of funding these various programs? According to most of the testimony we have heard today, you can't enforce the law. We have got the laws but they can't enforce them.

Well, if that is true, then why are we spending our time trying to write some more laws that we can't enforce? So it would appear to me that we need to go back to square one. We need to get back to where we start training and educating people again, teaching that, yes, you do have certain responsibilities and society is going to have to address it.

I don't think that government itself can address this question. I think it is much deeper than that. It is the very moral fiber of our

society. And you are not going to be able to do it by passing more laws. We are going to have to be able to get back to where more volunteerism is involved.

Ms. LOWRY. Can I say one more thing?

Chairman JOHNSON. I am going to move on, if I may. I absolutely have to leave at 2:30 and I left my questions till the end, and I want to at least give us a chance to focus a little bit more carefully, Ms. Lowry, on your challenge to the system. And I would like you and Mr. Petit to address the issue of, if the system is failing as badly as it is, and we have had a lot of testimony from a lot of different points of view that the system is not meeting the needs of America's children, it is also absolutely clear and we have put a lot of new money into this system, we have basically tripled the dollars in the last 5 years. There are not many programs in anyone's budget, public or private sector, Federal, State or local that we have done that with, and yet we are not addressing the problem.

Mr. Murphy in the preceding panel said you are not getting to the cause. Mr. Petit, that is what I hear you saying. I hear you saying, from my notes, that the system is crushing us with paper, that it is not working, and you mentioned getting serious about teen pregnancy. Get serious about child care in every school. I would assume, then, that teen parents would be sure to go to school, you would require that.

These are basically more welfare reform issues than they are actually foster care reform issues. Then you mentioned be sure to require inservice training and a good assessment process with a much greater, more flexible approach as to whom provides services. I would assume, you would even then allow the community-level church groups to develop, where the family support and frankly, the Federal level can't reach.

How do we bring together child services so that we get at Wade Horn's 25 programs? I mean, this is ridiculous. What do we put together—you may not want to be specific on this. But what are the things that should govern it and how do we hold it accountable and how do we get around the very real problems that Ms. Lowry has pointed to, though her solution actually sort of sounds to me like more of the same. I will give you plenty of time to answer.

I may have to duck out. And Mr. Cardin hasn't had a chance to speak, so I will ask one of my colleagues to take over. But if I don't get a chance to finish this with you now, I am interested in your input in the future.

Mr. PETIT. First of all, let me say that contrary to what sounded like in my exchange with Mr. Johnson, that I absolutely fundamentally believe, in the first instance, the role of government was to enable families to manage their own affairs in as minimally an intrusive a way as possible. I agree, sir, you cannot deputize half the population to watch the other half of the population, which is what we are moving toward right now.

So, in the first instance, I think it is a question of we must enable people to learn how to be better parents. We are not doing serious parenting around this country. It is a minimal kind of a program that is being offered only to those people who are perceived as being abusive.

We know much more about healthy human development than we ever knew before. All of the other Western industrialized countries have at the local level, not at a Federal level, but at a local level, home visitor programs to young families, especially families who are under the age of 21 years old.

When we asked a survey in North Dakota recently, we just did this for the entire State of North Dakota, 89 percent of a statewide survey of families said they would like to have a home visitation program, not of child protective workers but of public health nurses working with them. We also learned from 80 percent of the parents, that they said parenting was more difficult, they believed, than when their parents were parenting, and childhood is more difficult today than when they were children as well.

I think that there are two issues here that I would urge the committee to think about, one is a mechanical issue and it is the point Mr. Matsui raised. There are 3 million children every year being referred to legal organizations, governments that are supposed to examine those cases. That business of the mechanics of child welfare, what happens from the point that somebody dials 911 to the point of achieving a safe, permanent situation for children is a tremendously ignored area.

There has been no court representation here today. They are deeply involved with this whole matter, and right now, it is a very highly legalistic process, that everybody agrees lawyers don't put their hands on children. We need other people to be able to do that kind of thing. So all the steps in that process we would urge you to take a look at.

But the other issue that is surrounding all this are the causative factors that don't have anything to do with the mechanics of all of this stuff but have to do instead with the question of what is contributing to this problem in the first instance. We would submit right now that we have created a spawning ground, that will ensure that the country will be dealing with this for the next 20 or 30 years, unless we do much more front-end kind of work.

And in North Dakota right now, their legislature is debating a report that we have just prepared for them. It was convened by the legislature. It was a year-and-a-half long assessment. It involved more than 2,000 citizens in focus group discussions, all of the State agencies, all the local agencies trying to push decisionmaking down as finite as possible, all geared at how can families and then communities take care of their own needs.

We believe that children do best when families are attentive to their needs. Families do best when communities are attentive to their needs. And the reality is the country has not adjusted to the changing demographics in the post-World War II period, that basically has large numbers of adults outside the home with nobody watching children. That is a fundamental consideration irrespective of your income level.

They are going to embrace, we believe, perhaps, universal child care in North Dakota, using junior and senior high school students to run the child care facilities, with an appropriate adult, and with seniors, so the kids learn what parenting is all about. There is no role modeling going on, and to learn what a serious job it is.

So my point is, there are legal issues involved when the kids are brought to the system, that the courts and child welfare need to protect children who are literally at-risk of being injured or sexually assaulted. And when you have judges say to you, and prosecutors say to you, that I know that there are kids right now, we know who they are, we believe they are at home with their perpetrator and we don't have the hooks legally to get our hands into them, that is a question that I think needs to be addressed one State at a time, with some Federal oversight and support.

Chairman JOHNSON. Thank you.

Ms. Lowry, I do want you to answer this question. I want you to answer it fully. I may have to walk out in the middle, but I will talk with you about it later so I will hear the rest of what you said. I think it is important for the record, it is important for the committee.

I am going to turn the gavel over to Mr. Hancock so that Mr. Cardin will have a chance to question, if he cares to, or they will have a chance to follow up, if they care to.

Ms. LOWRY. Thank you.

On the question of more—whether this—what I am recommending is simply more of the same. Let me say a couple of things. The kinds of things that Mr. Petit is talking about, different kinds of programs, better programs, teenage pregnancy, front-in services, all that is not contrary to what I am saying.

All I am saying is, number one, things aren't good now but look where they were in 1980. Nobody had an idea of what a case plan was or the need to have a case plan. We didn't know how many kids there were. They were out in large institutions in the country. There were families that would have adopted them and they weren't being asked.

Witness the fact that after the statute passed in 1980, when we had a population of 500,000, the population dropped to 270,000 within the next 3 years. So I am not saying that things are great now, goodness knows, anybody who has looked at any of the lawsuits, knows that I don't think that things are better now, are OK now. But we need to have legally enforceable standards and they are not standards that say how many hours a day you have to keep your child within your eyesight. They are standards that say, as a general matter, when things get so bad that the government gets involved, not when somebody just walking down the block gets involved, but when it gets so bad—and what we are talking about really is kids who are left alone in their homes for 3 days with no food. That is really the kind of stuff we are talking about and that is very common.

I don't know any—just like Mr. Petit, I don't know any system that is worried about a hot breakfast for a kid. They are worried about the kids dying of malnutrition because that is what we are talking about. What I am saying is, we have got to have those general standards and they have got to be enforceable.

You asked me, I think, Mr. Hancock, a few minutes ago, what difference does it make, the laws aren't being followed? Well, either they can be followed by virtue of the Federal Government exercising some general oversight responsibility, allowing the States flexibility to decide how they are going to protect kids, but then making

sure that they have got some program that protects kids, or they can get followed in the way that my organization, the Children's Rights Project becomes involved. And that is when States sink so far below a minimally acceptable level, as happened in the District of Columbia—which is not a State, of course, but nevertheless, was held to the Federal standard—the kids have to get their day in court, not on individual situations, although they form part of the information, but when you have a system that has workers that carry caseloads of 150, that is not a system that can protect anybody.

And so that is the importance of looking at this from a systemic perspective and from having general, enforceable standards that either the States will follow, because otherwise, the Federal Government is going to bother them, or worse comes to worse—and, obviously, it should be the last recourse, somebody is going to make them talk about in front of a Federal judge.

Mr. HANCOCK [presiding]. The gentleman from Maryland.

Mr. CARDIN. Thank you.

Let me thank each of you for your testimonies today. This is, obviously, an extremely important subject, and we are trying to seek good advice as to what we should do. I guess the frustrating part is I haven't yet met anyone who doesn't think the system is in need of significant change. Where we seem to be frustrated is what type of change will bring about a constructive result. And we haven't been able to come to, I think, a consensus on that. And I am hoping that your testimony will help us to reach some agreement.

I agree with Mr. Petit, in that the welfare of our children is the responsibility of all of us, starting first with our families, but government has certainly a very important role when it comes to the welfare of our children. And I strongly believe in federalism. Section 427 reviews have been troublesome to my State and they have been in to see me about changes.

So I guess my question to Mr. Cooper, who has done such a wonderful job here in Maryland: What if we were not to have Federal standards at all? What impact do you think that would have on our children? What response should the States come forward with?

Mr. COOPER. The hearing today is focused on the 427 requirements and, for example, the periodic review that looks at the case plan and says are we going in the right direction for the child? I think even our Federal—our State administrators, as well as our citizen reviewers, would agree we should have that and we have to have that. And if the Federal Government takes that away, we will have to put it back in through State laws. So that is something we need to keep.

I think we have missed a point here today, and I am just speaking for myself. But the IV–E requirement, one, that pays the foster care maintenance payment to the State, is costing States a lot of administrative waste.

What happens? If a child comes into foster care and they are on AFDC, or they would have been on AFDC, the Federal Government will pay a share. If they wouldn't have been on AFDC, maybe it was that family Mr. Henry was talking about, where both parents work the minimum wage. Well, we won't pay for that child. So what happens in Maryland, we spend about $1 million a year de-

termining whether the kid was poor enough. What does that have to do with it and what Federal interest is advanced by making that determination?

I think that is a significant area of paperwork reduction that we could do, and that is not to say that we should do away with some other requirements, like the fact that before a child is brought into foster care, a court should have found that there were reasonable efforts to try to help the family keep the child safe within the family. We ought to keep that, but throw out the income redetermination.

I think we need more research into some of these issues like, when is family preservation appropriate. I think that the Federal Government could make a real contribution there, because I don't think we now—I think we have to keep working on the courts. There is a small Federal amount of money to get the courts to improve themselves, and I think we need to keep doing that.

Mr. CARDIN. Let me try to have you focus on Federal standards for just one moment. Is your concern that if we were not to have Federal standards, there would be a lack of uniformity among the States, or are you afraid that the States would not establish adequate standards in order to protect our children?

Mr. COOPER. I am particularly—I have to say from my point of view, I am particularly afraid of the States right now that don't have citizen review. Because I think in Maryland, where we have 400 citizens actively now and probably 1,000 citizens that have been through and heard cases about—like Ms. Howze's case, we would have reviews in Maryland and we would get them enforced.

I mean, the Federal Government, in putting that requirement, made a big difference in our effectiveness in setting up, and I think we are there now. But what about—if citizens reviewed 50,000 kids, then that is about 10 percent. What really concerns me is that I think that—and Mr. Petit spoke about the tremendous variations that we have in child welfare. So, yes, uniformity of quality is a big concern. And we need to—we need to make these—we need to look at these requirements again to get more outcome oriented. I am going to try to write in some suggestion about that.

Mr. CARDIN. Let Mr. Petit have a chance.

Mr. PETIT. Let me say, right now, the States are not burdened by much in the way of standards. There are 11 volumes of standards by the Child Welfare League. There are many volumes on the Council of Accreditation. There are no States in compliance, because they are on a voluntary basis.

They have been around for years and years. The States have caseload ratios that range from 15 to 1 to 20 to 1, to some instances, at a practical level, 120 to 1, which is impossible to do serious casework on that.

We think the States and the Federal Government, working with private volunteer agencies ought to actually agree on what standards to hold themselves to jointly, and then based on that, ought to create the tension within the system that everybody holds each other accountable.

Right now, there are no real standards that are uniformly applied, and the States are rarely, if ever, sanctioned as a result of this. And I don't think this is a question of Big Brother, Federal

Government watching the States. The difficulty is with a country as big as ours, and with much of this being done with local jurisdictions with county assistance, who provides technical assistance to the States and counties that want to do a better job in this area?

Mr. CARDIN. That was my point. You see inconsistencies within States because of local governments?

Mr. PETIT. We see inconsistencies within States, we see inconsistencies within counties, and we see inconsistencies within five socialworkers responsible to the same supervisory officer. In many instances, they are freelancing on their own, making decisions about who comes, who goes, what the point of intervention will be.

That is what happens when there is a lack of vigorous accountability, training. The States ought to be holding themselves accountable, and it is very weak in many jurisdictions.

Mr. CARDIN. I will give Ms. Lowry the last 30 seconds.

Ms. LOWRY. Thank you.

There are general standards in the Federal law now. They are very general. And the States can do a wide range of activities and comply. But there are standards that say there has to be a case plan within a specified time.

The case plan has to say specific things. The plan has to work toward permanence. The children have to be in homes or facilities that generally conform with nationally acceptable standards, hence, Mr. Petit's organization, standards.

Again, there is a wide range of flexibility, but it is a framework. They can't take a kid into care and not plan for the kid at all.

On the other hand, they can try all different approaches to try to achieve permanence for a kid. So there are some minimal standards. They are not very stringent and the State really can enforce them a lot of different ways. But taking those away and leaving nothing, I fear, would be very, very bad for kids.

Ms. DRIVER. May I speak to your question?

Mr. CARDIN. Sure. I would urge, though, that we look at not necessarily making the Federal standards more stringent or more relaxed, but making it a system that can work. The current system is not working, so we need to figure out a way in which there is really a partnership with the Federal Government working with the States in a realistic regulatory system.

Ms. LOWRY. Right. If I may, I think one step has been taken in that direction by changing the 427 sanctions. It used to be that if the Federal Government reviewed a State and found that it didn't meet the standards, the Federal Government's only option was to simply cut off funds, which wasn't very helpful to a State that was floundering. Now, as a result of some legislation that passed in the fall, the State—the Federal Government has an escalating series of activities, including providing technical assistance to the State. That is a way to, I think, work better.

Mr. CARDIN. No question, we improved it. We still have some old issues that are outstanding.

Ms. LOWRY. Without a doubt. But the problem isn't, I think, as Mr. Petit says, that anybody says the States were overburdened with standards. They are very loose standards. The problem is there hasn't been any pressure to make them comply with even the loose standards that exist.

Mr. CARDIN. Thank you.

Ms. Driver.

Ms. DRIVER. Yes. In response to your question about standards in States that don't have citizen review, Iowa, has just—is building up its citizen review system now under legislative mandate and they are under a trial. A case plan is, one would think, a normal thing when you take a child from a home, and one of the things—mind you, 98—96–272 has been in existence since 1980. You would think that there would be case plans in every case in the State of Iowa.

And I am not trying to pick on Iowa. It is just that this is one State where we have been gathering some data. And the number of children who did not have case plans was incredible, until foster care review boards came into existence, and they have seen a marked increase in the number of case plans.

And I would like to, on another subject, thank you for your interest in the subject and the question of citizen review and oversight, for working to get some report language in the Omnibus Budget Reconciliation Act 2 years ago.

Mr. CARDIN. Thank you.

Ms. DRIVER. Thank you.

Mr. CARDIN. Thank you for your patience, Mr. Chairman.

Mr. HANCOCK. The Chair would like to thank you for your testimony and taking the time to give us some very useful information.

With that, this hearing is adjourned.

[Whereupon, at 2:45 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

Benbrook Insurance Agency, Inc

901 Main Street -- P. O. Box 1267
Woodward, OK 73802-1267
Phone 405 256-5766 -- Fax 405 254-2605

February 6, 1995

Phillip D. Moseley
Chief of Staff, Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

RE: Testimony to the Ways and Means Sub-Committee
concerning Establishment of Citizen Review of Child Placement.

Dear Mr. Moseley:

I am volunteer reviewer on a Citizen Review Board in Oklahoma and Vice Chair of the Oklahoma State Review Board and I would like to communicate my thoughts to the Sub-Committee concerning the need for citizen review.

One of the first cases I reviewed involved "Rhonda", eight, who had been sexually abused by her mother's boy friend. She and her brother, "Jake" were abandoned by their mother in 1992 when the State took custody. Parental rights were terminated quickly and the children were placed in foster care.

Rhonda's emotional problems and sexual acting out were severe. Jake, a bright five year old, did not exhibit the same problems. It was obvious that adoptive parents for Rhonda were going to be difficult to find. Even though it would be preferred to place these children together, our review board asked the court to consider separate placement. An adoptive family was found for both children but it failed after six months. In the spring of 1993, the children were placed together in therapeutic foster care. They receive counseling from a psychologist to help them recover from the failed placement.

In two months this case will be three years old. Rhonda is eleven and Jake is eight. Rhonda's behavior is better, but she still acts out sexually and might be described as a pubescent Lolita that seeks affection sexually. Jake remains an intelligent little boy.

The policies and procedures of Human Services require that they make every effort to place these children together. This is commendable but very limiting for Jake. The Reviewer's job is to point out to the Court that even though the bond between these children is very strong another failed adoption will cause great damage to both children. It may be in Jake's best interest to place him separately providing for visitation with Rhonda. Rhonda will remain in foster care until a separate placement for her can be found. It is unfair to use Jake as bait so that these children can be placed together.

Citizen review is mandated to recommend to the court what is in the best interest of the children. While courts may not have time to hear from everyone involved with these children, we communicate with foster parents, schools, physicians, counselors, attorneys, and others to gather information about these children. We then make recommendations to the court that are not constrained by hundreds of pages of policies and procedures. These recommendations reflect the standards and expectations of our communities where we and these children live.

Citizen Reviewers make recommendations to the court that originate from a desire to meet the needs of the child and protect society without the constraints of agency policies or the limitations imposed by procedural rules. When Human Services and the court work with the Citizen Reviewers as members of a team committed to the needs of society instead of as adversaries, the collaboration has a positive impact.

Citizen review should be required for every child in the State's care to insure that all children and families in the system receive appropriate services. Thus reducing the tendency to slap a Band-Aid on family problems only to see the families reappear a short time later for another Band-Aid.

Reviewers should conduct administrative reviews every six months to ascertain appropriateness and effectiveness of service plans. Such reviews would assure that plan and court goals are being met and reduce need for semi annual court review. Such a forum should also seek independent input from the children, parents, foster parents, schools, physicians and other service providers that generally do not communicate to the court or with each other. This is an inexpensive way to reduce the stress on the court system caused by excessive case loads while retaining the quality and appropriateness of services provided.

Uniform data gathered by review boards and compiled by the State and National Association of Reviewers would be useful to Congress in evaluating the efficacy of service providers, agency policies and court operation. This information system will have a low implementation and maintenance cost. This information flow would also be unencumbered by the bureaucratic infrastructure that bedevils the current Juvenile and Child Welfare systems.

As members of the community citizen reviewers have a unique capacity to see that the services received by troubled children their families are appropriate. We welcome the opportunity to serve the our children, families, communities and courts.

Mac Benbrook

Citizen Reviewer and
Vice Chair, Oklahoma State Review Board

cc by fax: Donna S. Steele, Counsel
Committee on Oversight
202 225-9680

STATEMENT OF ROSEMARY WINDER STRANGE
DIRECTOR OF SOCIAL SERVICES
CATHOLIC CHARITIES USA

Madame Chairwoman, Thank you for the opportunity to provide written testimony regarding block granting and 427 reviews. We oppose block granting to the states these federally mandated programs as well as the elimination of the requirements of section 427.

Catholic Charities USA is the nation's largest, private, social service organization. The network of 1,400 agencies and institutions and thousands of concerned individuals works to reduce poverty, support families, and empower communities in the United States.

Catholic Charities agencies and institutions, with more than 266,000 staff members and volunteers, provide social services ranging from adoption and counseling to food and housing. People of all religious, national, racial, social, and economic backgrounds receive services from Catholic Charities. We provide a full range of services to families and children. We operate modern homes and treatment centers for children.

Catholic Charities USA promotes public policies and strategies that address human needs and social injustices. More than 10 million people turned to Catholic Charities for help in 1993. Three million of those individuals were children and adolescents who were 17 years of age or younger.

Catholic Charities agencies have a long and proud history of making permanent placement plans for children in need of families. Even before 1910 when the National Catholic Conference (now Catholic Charities USA) was founded, our agencies were providing quality permanent placement plans for children available for adoption.

As stated by the National Conference of Catholic Bishops in its 1992 Pastoral Statement, *Putting Children and Families First,* Catholic Charities USA believes that "no government can love a child, and no policy can substitute for a family's care. But government can either support or undermine families."

The Adoption Assistance and Child Welfare Act was signed into law in June 1980. This legislation (P.L. 96-272) addresses matters that pertain to both the entry and exit of children from care. It includes measures to stop the drift that characterized the tenure of many children in placement. The law requires that states know what is happening to children in their care, and it redefines the relationship between federal and state government with respect to children at risk of placement and those already in care. This is accomplished mainly through a fiscal restructuring that offers states incentives to accomplish the goals of the act.

Public Law 96-272, the Adoption Assistance and Child Welfare Act of 1980, and the child protection under Section 427 of the act corrected many abuses of the past which we do not want to see revisited. A whole range of services to children and their parents are necessary to support the family unit; and when placement is necessary, to reunite the family as quickly as possible.

In 1993 Catholic Charities agencies cared for 51,403 children in residential facilities, group homes and foster home care. These children were from all economic levels who could not live with their parents for a variety of reasons including the child's treatment needs and parental neglect and abuse. Our services allowed families to stay together. Other times our services determined which children needed to be removed from their homes, temporarily or permanently. This range of services is what is required by the 427 reviews.

We acknowledge that there have been abuses in the interpretation and application of the 427 reviews. In an effort to speedily return children to their parents, discharge plans are made which are not always in the best interests of the child or the family. Catholic Charities USA views Public Law 96-272 as a step in the right direction while acknowledging its shortcomings.

We too are concerned about the abuses. Residential care is sometimes the level of care a particular child needs at a particular time, but foster care is seen as "least restrictive." As a result, many children are bumped from foster home to foster home and risk becoming emotionally disturbed. These children eventually require more expensive residential care and treatment. Some children never get a stable home. Due to funding shortages, child protective services and other child welfare services are understaffed, and workers are poorly trained. Eliminating any of the requirements of P.L. 96-272 and the other federal child protections would set the field of child welfare back fourteen years and would be a detriment to the children and families of our nation. Let's correct the abuses, but let's not wipe out what has been accomplished.

We fear that block granting federal child welfare services and foster care programs back to the states will limit the funds available for these critical children's services as demands increase. Adoption assistance and foster care are entitlements to individuals. Block granting would change the nature of the child's right to a protective safe environment either through the foster care or adoption system.

Thank you for this opportunity to offer testimony to The Ways and Means Subcommittee On Oversight.

Old Arroyo Chamisa #32A
Santa Fe, NM 87505

1 February 1995

Mr. Phillip D. Moseley, Chief of Staff
Committee on Ways and Means
US House of Representatives
1102 Longworth House Office Bldg.
Washington, DC 20515

Dear Sir,

The people who have lent their names to this letter are citizen volunteers on two boards in New Mexico's Foster Care Citizen Review program. We are writing to register our support, in the Ways and Means Subcommittee hearings on child welfare programs, for consideration of expanding citizen review as a responsible, effective, and economical way to improve the effectiveness of child welfare programs and provide protection to foster children.

We commend this subcommittee for undertaking to examine what is happening to the children who, through no fault of their own, are caught up in systems that, despite good intentions, are not meeting their needs.

From our familiarity with state and local social service programs, we would point out that, because of citizen review, foster care is the **only** social service program in which service effectiveness is monitored client by client, with participation of client-children and families as well as all others involved in providing care and services, right at the service delivery level of the family and child. We are at the forefront of assuring that abused and neglected children get the services they need, and get permanent families at the earliest possible time. No other public bureaucracy or court procedure even approaches this degree of monitoring and quality assurance. A small number of dedicated volunteers are able to assure that thousands of children do not languish unncessarily in temporary care when what they need is a loving and nurturing family. No internal or administrative review can begin to meet the kind of standard of objective, independent review afforded by citizen reviewers.

We urge the subcommittee to consider for recommendation that every child in the custody of a public child welfare agency be assured of an independent citizen review by requiring all states to establish such safeguarding procedures. Such reviews should be required at six month intervals.

Courts should be required to utilize such review information in their judicial reviews of children in legal custody.

States should also be required to establish a state review board, consisting primarily of citizen reviewers, which reports annually to state executive, legislative, and judicial agencies and to the Federal funding agency for reporting to Congress on the utilization of Federal funds.

The law should provide both incentives and penalties to states for effective or ineffective implementation of review requirements.

We believe the National Association of Foster Care Reviewers, the primary representative of the 24 states now having some citizen review, is the appropriate vehicle for providing training to states and citizen reviewers, for directing the gathering of uniform data for reports to the Federal agency and to Congress on the status of children in substitute care, and the progress being made in remedying the problem of nearly one-half million children who now do not have permanent families.

Funding for citizen review programs should go directly to state boards in order to ensure their independence from any state agency or courts which control the services provided to abused and neglected children. Funding for the national training, data collection and reporting to the Congress and the Federal agency should be directed to the National Association of Foster Care Reviewers to assure that its operations are conducted independent of any Federal or state agencies controlling child protection programs.

Our thanks once again to the Subcommittee on Oversight and its chair, Rep. Nancy L. Johnson, for undertaking this important issue.

The following Citizen Reviewers have authorized their names to be appended to this letter.

Sally J. Evans

Julia S. Nathanson

Vera L. Kegel

Theodora Baer

Joseph E. Paull

Laura L. Dunmar

Shirley Steiner

COMMONWEALTH OF PENNSYLVANIA
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P.O. BOX 2675
HARRISBURG, PENNSYLVANIA 17105-2675

Michael J. Breslin
Executive Deputy Secretary

Telephone 717-783-4284

FEB 0 6 1995

Mr. Phillip D. Moseley
Chief of Staff
Committee on Ways and Means
U.S. House of Representatives
Room 1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Moseley:

Attached are six (6) copies of written testimony on Pennsylvania's child welfare programs for submission to the U.S. Ways and Means Subcommittee on Oversight. The deadline for submission is Tuesday, February 7, 1995.

Thank you for the opportunity to provide testimony on the structure and funding of child welfare programs at the federal level.

Sincerely,

Michael J. Breslin

Attachment

I want to express my sincere thanks to the Honorable Nancy L. Johnson and the members of the Subcommittee on Oversight of the Committee on Ways and Means for the opportunity to provide testimony on the structure and funding of child welfare programs at the federal level. Your commitment to moving quickly to review and address areas of federal/state relations that involve mandates and impose burdens on states is greatly appreciated and long overdue.

As child welfare needs and costs have multiplied, federal support for child welfare programs has become indispensable. Federal programs currently fund 37 percent of the cost of Pennsylvania's child welfare services. But, each federal program is accompanied by procedural, monitoring and reporting requirements. These requirements not only add significantly to paperwork and administrative responsibilities of staff, but also inhibit program flexibility and the freedom to experiment with program funds. My statement will propose some modest changes to reduce federal Title IV-B funding requirements as well as provide a few comments on the importance of continued federal funding for state child welfare programs.

I will begin by addressing Pennsylvania's experience in implementing Section 427 of Title IV-B.

The case planning system and court review requirements of P.L. 96-272 have changed the way public child welfare agencies in Pennsylvania do business. Before P.L. 96-272, parents voluntarily placed their children and sometimes were never able to get them back. Parents were prohibited from knowing where their children were and were not allowed to visit with any regularity. Private agencies accepted children into placement without the involvement of any public authority or the courts. With P.L. 96-272, county children and youth agencies fully assumed the following responsibilities:

--they assumed active responsibility for case management and decision-making about placement of children and their return home in conjunction with the courts;

--they assumed responsibility for determining case goals and assessing progress toward those goals;

--they assumed responsibility for bringing parents into the case planning process in a meaningful way so that parents had goals to achieve after which their children would be returned;

--they assumed responsibility for working with the courts to establish a case review system for all children in placement which assures that goals are appropriate and that progress is being made toward achieving those goals; and

--they assumed responsibility for compliance with federal and state funding requirements which hold all of us accountable for the public funds expended for these services.

All of these responsibilities have made the child welfare system more accountable to the public, to parents, to those who work in the system and to the courts, and have improved the quality of service to children in out-of-home care.

Pennsylvania has a strong record of achievement in Section 427 compliance. We have met the federal standards in all Section 427 reviews and have achieved 100 percent compliance in a majority of those reviews.

While we believe strongly in the importance of the Section 427 requirements, we also believe that federal enforcement of the requirements through program audits is no longer necessary. State laws, operating policies and procedural safeguards supporting and reflecting a philosophy of family preservation have been an integral part of Pennsylvania's child welfare system for the past 12 years. Federal Section 427 audits are time consuming and

expensive, especially for a county administered child welfare system such as Pennsylvania's. For these reasons, I am recommending that the Title IV-B Section 427 requirements be eliminated or, if this is not possible, that each state be able to self certify that it meets the requirements of Section 427.

Next, I will address the planning requirements contained in Title IV-B as amended by the Omnibus Budget Reconciliation Act of 1993 (OBRA '93) and make a recommendation on future funding of state child welfare service programs.

OBRA '93 amended Title IV-B to create a new capped entitlement program for family support and family preservation services. OBRA '93 authorizes formula grants to states totaling $60 million in Federal Fiscal Year 1994 and increasing to $255 million by Federal Fiscal year 1998 to fund the new family support and family preservation program. Pennsylvania's share of these funds was $2.360 million for Federal Fiscal Year 1994 and will be $9.755 million in Federal Fiscal Year 1998. While these funds are needed in Pennsylvania, we are concerned that the creation of another categorical program will further fragment funding and limit state flexibility to meet specific state needs.

OBRA '93 also changed and expanded the state planning required to be eligible to receive Title IV-B funds. The new Title IV-B plan requirements are more extensive and prescriptive than the previous planning required by Title IV-B. The new planning requirements specify whom states must involve in the planning process and mandate a statewide needs assessment, extensive program inventories, the targeting of resources, and the development of data systems to monitor the achievement of goals and report to the federal government.

Prior Title IV-B planning requirements allowed states to define their own planning process and to determine for themselves who would be involved in the planning process. In Pennsylvania, we have used Title IV-B planning to define priorities for the development of our child welfare system in ways that make the most sense to Pennsylvania. The process has helped to build a partnership between the State and local communities and to address the most important needs of our child welfare system. We believe the new planning requirements go too far in specifying how states must plan for child welfare services.

Pennsylvania is establishing a community-based, interagency, comprehensive approach to the delivery of services to children and families. State flexibility in the planning and use of Title IV-B funds is important to the continuing development of this cross-system approach to child and family services. The OBRA '93 child welfare amendments have made Title IV-B more categorical and prescriptive. Merging the two parts of Title IV-B into a single child welfare block grant along with a return to the prior planning requirements will reduce costs to the states and return flexibility to the program.

In closing, I wish to offer a few general comments on federal funding of state child and family service programs.

There are over 70 federal programs administered through state government in Pennsylvania that are designed to address specific child and family health and welfare issues. This array of services, each with its own discrete eligibility criteria, rules and procedures, contribute to a complex, categorical and rigid system that focus on specific problems rather than on comprehensive family needs. Our hope is that you will reduce the complexity of federal funding and provide states and communities with the flexibility to design local strategies that will keep families together as well as protect and care for those children who cannot remain with their own families. As new funding approaches are considered, other related funding streams, such as health and

education, should also be reviewed so that the complexity of programs and funds provided to states can be streamlined and merged. The emphasis must shift from a program specific focus to one that addresses broad child and family outcomes.

Child welfare programs are funded primarily through four federal revenue sources: Title IV-B, Title IV-E, Title IV-A emergency assistance and Title XIX Medicaid. While a more consistent approach and greater flexibility in federal requirements for these programs is needed, changes in any of these funding sources which do not respond to changes in the level of client need will create a significant financial burden on states and local communities.

The cost of child welfare services has increased dramatically during the past five years. Despite our best efforts to preserve families and prevent the placement of children, the number of children in need of foster care continues to grow. Budgeted costs for children and youth services in Pennsylvania for the current fiscal year are $826 million. Just five years ago, in fiscal year 1989-90, total costs for Pennsylvania's children and youth system were $457 million. This is an 80 percent increase in five years. Seventy-five percent of the cost of these services is the result of foster care placements.

The dissolution of families and the decay of communities has led to this continuing demand for substitute family care. Out-of-wedlock births, teen pregnancy, drug abuse, and the increase of single parent families are major problems affecting the need for child welfare services that will require the involvement of all sectors of our society to solve. It is essential that states have the flexibility to work with local communities that can develop local interventions and prevention strategies to build strong families and communities. As indicated previously, it is the myriad of discrete programs with a single focus that tie the hands of those at the local level trying to address comprehensive family problems. We must work to keep families together and provide our communities with the resources, capacity and flexibility to do the job.

WRITTEN COMMENTS FROM
CAROL A. BRUNTY, COMMISSIONER
VIRGINIA DEPARTMENT OF SOCIAL SERVICES FOR
THE COMMITTEE ON WAYS AND MEANS
SUBCOMMITTEE ON OVERSIGHT

February 7, 1995

Public Law 96-272, the Adoption Assistance and Child Welfare Act of 1980, was passed to provide valuable protections for children that were at risk of out-of-home placements. Prior to this legislation, systems among the states varied radically. It was not unusual for children to be caught in "foster care drift" and "forgotten children" was a descriptive term for these children. With passage of Public Law 96-272, public policy was changed and states were held accountable for the children in their care. Permanency planning became the goal and services were focused on keeping children with their birth families. If children had to be removed, Public Law 96-272 sought to assure (i) return to safe birth homes, or (ii) timely placement with adoptive families. To achieve this goal, states were required to develop and implement automated information systems, case reviews and service planning. Compliance was to be determined through federal audits which were to focus on 18 specifically identified safeguards.

Virginia was one of the first states to make effective use of the permanency planning concept. We embraced the permanency planning philosophy, instituted a system of case review, and developed an automated tracking system as early as 1976. Consequently, by June 1994, there were 6313 children in foster care throughout the state. This was 4990 (44%) fewer children in care than in 1976 when the permanency planning concept was initiated.

Few child welfare professionals will argue with the philosophical intent of the Act. Through implementation, the lives of children have been positively impacted. More children are being kept in their birth families, the length of time a child remains in foster care has decreased, and more children are achieving adoption than ever before.

Nevertheless, we still have a long way to go in meeting the critical needs of children and families. There are three issues that merit serious consideration: accountability, flexibility, and resources to carry out the intent of the Act.

Accountability

Although significant progress was made after the protections of Section 427 of the Social Security Act were developed, the federal approach to monitoring these requirements has focused more on procedural requirements and checking of boxes than on quality of service provision. For example, the focus of federal reviews has been on the *timeliness* of administrative panel reviews and dispositional hearings rather than on the service outcomes. Similarly, the *existence* of a service plan has been seen as the critical element, rather than the actual service planning process and the services that were provided.

While this approach may have been appropriate initially to ensure uniform compliance among states, we need to move beyond just a paper review to a monitoring process that focuses on the true intent of the Act. Passage of a 427 audit, as it currently exists, has little to do with the effectiveness of a child welfare program. More than half of the states are involved in some kind of child welfare litigation or are operating under consent decrees. Many of these states had passed 427 audits without difficulty. The time has come for us to begin looking at the appropriateness and quality of services being provided and at the outcomes being achieved as a result of these services.

Whether monitoring continues to be a function of the federal government or is taken over by the states, this type of monitoring is certain to present a tremendous challenge. However, movement in this direction is essential if we are to reform and improve the child welfare system while building on the knowledge we have gained in the past decade.

Flexibility

Flexibility is also an essential component of any attempt to reform current systems. Virginia has recently redesigned its approach to service provision. In 1992, the General Assembly enacted legislation entitled the Comprehensive Services Act. Passage of this act dramatically altered the administrative and funding systems providing services to at-risk youth and families. The purpose of the act was to create a collaborative system of services and funding that is child-centered, family-focused and community-based. Services and funding are consistent with the Commonwealth's policies of preserving families and providing appropriate services in the least restrictive environment, while protecting the welfare of children and maintaining the safety of the public. Early intervention, interagency collaboration, family involvement, public and private partnerships, and community flexibility in decision-making and the utilization of funds characterize this innovative system.

With this act, an administrative structure was developed and funding from five human service agencies was combined to carry out this initiative. Although findings from numerous studies indicated that redesign of Virginia's service system was essential and that the proposed structure was the most effective and cost efficient, implementation was an unnecessary challenge because of existing categorical funding limitations. Categorical funding from the federal government has inhibited Virginia's ability to de-categorize the needs of children and families even with our new system.

The bottom line is that we believe we are doing some things right in the Commonwealth. Virginia is not unique, nor is it any more creative than other states. Given the opportunity, states have proven their ability to develop programs and services that meet the needs of their citizens and that are cost effective. Therefore, we would advocate for a reduction in costly and burdensome federal regulations and an increase in state flexibility.

Current funding streams limit populations that can be served, creativity in developing services needed by local communities, and flexibility by states to improve services to their citizens. Block granting, which would allow more flexibility and creativity on the state level, could be advantageous in moving toward more effective service systems. Effective block granting would include indexing that will accommodate state population growth, triggers that allow "uncapping" of the block grant during times of increases in the child welfare caseload, and incentives for states that are based on achievement of positive outcomes, rather than punitive penalties for not meeting process requirements.

Resources

Although block granting has the potential for encouraging more creativity and flexibility on the state level, careful consideration must be given to the structure of any block grant design.

Currently, Title IV-E, which provides states with funding for administration, training, and maintenance expenses is an open ended entitlement program. With the creation of block grants, funding

could be capped at a level that would restrict the development of innovative programs and services and which would preclude the state's ability to develop qualified resources. Observation of those states that have undergone consent degrees, as a result of suits being filed by the American Civil Liberties Union, shows that resources are one of the most critical components in an effective service delivery system. With increased, qualified resources, outcomes for children in these systems have improved significantly.

Summary

The federal government has taken an essential leadership role in shaping the direction of child welfare service systems. Federal 427 reviews were instrumental in moving states away from antiquated systems that encouraged foster care drift toward service systems that resulted in beneficial outcomes for children and families. Progress now demands that we move beyond the traditional monitoring approach to an approach that forces states to move even further toward positive outcomes. Block grants have the potential for giving the states necessary and appropriate flexibility in developing approaches that best meet the needs of their citizens. Structuring of block grants must include indexing for population growth and incentives for achievement of positive outcomes.

The challenge before us is structuring a funding stream that contains the components of public accountability, flexibility for individual states, and incentives for achievement of positive outcomes. We believe the concepts of Public Law 96-272 are still valid, but future measurement of state child welfare systems must be based on achievement of agreed upon outcomes or benchmarks that are child centered, family focused, and community based.

ISBN 0-16-047682-8

FCC MINORITY TAX CERTIFICATES

HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

OF THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDRED FOURTH CONGRESS

FIRST SESSION

JANUARY 27, 1995

Serial 104–10

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SUBMISSIONS FOR THE RECORD

FCC MINORITY TAX CERTIFICATES

FRIDAY, JANUARY 27, 1995

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT,
Washington, D.C.

The subcommittee met, pursuant to call, at 10:20 a.m., in room B-318, Rayburn House Office Building, Hon. Nancy L. Johnson (chairman of the subcommittee) presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON OVERSIGHT

For Immediate Release
January 18, 1995
No. OV-2

CONTACT: (202) 225-1721

JOHNSON ANNOUNCES DETAILS OF HEARING ON FCC PROVISION

Congresswoman Nancy L. Johnson (R-CT), Chairman of the Subcommittee on Oversight of the Committee on Ways and Means, today announced that the subcommittee will hold a hearing to examine the operation and administration of a tax provision which allows the Federal Communication Commission to grant tax relief with respect to the sales of radio, television, and other properties under certain circumstances. This provision is known as Internal Revenue Code section 1071. **The hearing will be held on Friday, January 27, 1995, in room B-318 of the Rayburn House Office Building, beginning at 10:00 a.m.**

BACKGROUND:

Code section 1071 was enacted in 1943 to address concerns with respect to involuntary conversions of radio stations arising from wartime restrictions on the purchase and availability of new radio property. Under section 1071, gain from the sale or exchange of broadcast facilities may be deferred in cases where the sale or exchange is certified by the Federal Communications Commission "to be necessary or appropriate to effectuate a change in a policy of, or the adoption of a new policy by, the Commission with respect to the ownership and control of radio broadcasting stations...."

In 1978, the FCC announced a policy of promoting minority ownership of broadcast facilities by offering a tax certificate to those who voluntarily sell such facilities to minority individuals or minority-controlled entities. Since that time, the FCC has issued over 300 such tax certificates. Recent press reports about the FCC's administration of section 1071, both in terms of the types of properties covered and the size of the tax benefits being granted, raise significant questions about this provision.

FOCUS OF THE HEARING:

The Subcommittee will examine: (1) whether the FCC's 1978 policy is consistent with the underlying intent of section 1071; (2) whether the FCC's administration of section 1071 constitutes an impermissible exercise of legislative authority; (3) whether the tax incentive provided in section 1071 in fact fosters minority ownership of broadcast facilities; and (4) whether the FCC policy is a necessary or appropriate means of achieving this goal.

DETAILS FOR SUBMISSION OF REQUESTS TO BE HEARD:

Requests to be heard at the hearing must be made by telephone to Traci Altman or Bradley Schreiber at (202) 225-1721 no later than the close of business on Monday, January 23, 1995. The telephone request should be followed by a formal written request to Phillip D. Moseley, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. The staff of the Subcommittee on Oversight will notify by telephone those scheduled to appear as soon as possible after the filing deadline. Any questions concerning a scheduled appearance should be directed to the Subcommittee staff at (202) 225-7601.

In view of the limited time available to hear witnesses, the Subcommittee may not be able to accommodate all requests to be heard. Those persons and organizations not scheduled for an oral appearance are encouraged to submit written statements for the record of the hearing. All persons requesting to be heard, whether they are scheduled for oral testimony or not, will be notified as soon as possible after the filing deadline.

Witnesses scheduled to present oral testimony are required to summarize briefly their written statements in no more than five minutes. **THE FIVE MINUTE RULE WILL BE STRICTLY ENFORCED. The full written statement of each witness will be included in the printed record.**

In order to assure the most productive use of the limited amount of time available to question witnesses, all witnesses scheduled to appear before the Subcommittee are required to submit 200 copies of their prepared statements for review by Members prior to the hearing. **Testimony should arrive at the Subcommittee on Oversight office, room 1136 Longworth House Office Building, no later than noon, Thursday, January 26, 1995.** Failure to do so may result in the witness being denied the opportunity to testify in person.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE:

Any person or organization wishing to submit a written statement for the printed record of the hearing should submit at least six (6) copies of their statement by the close of business on Tuesday, February 7, 1995, to Phillip D. Moseley, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements wish to have their statements distributed to the press and interested public at the hearing, they may deliver 200 additional copies for this purpose to the Subcommittee on Oversight office, room 1136 Longworth House Office Building, at least one hour before the hearing begins.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. Statements must contain the name and capacity in which the witness will appear or, for written comments, the name and capacity of the person submitting the statement, as well as any clients or persons, or any organization for whom the witness appears or for whom the statement is submitted.

4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and the public during the course of a public hearing may be submitted in other forms.

*****

Chairman JOHNSON. Good morning, everyone.

I regret our late start, but we will try to move along. Today the Oversight Subcommittee will examine the operation of a provision in the Internal Revenue Code that allows the FCC (Federal Communications Commission) to grant tax benefits with respect to the sales of radio, television, and other broadcast properties. That provision, Internal Revenue Code section 1071, was enacted in 1943 to address concerns with respect to the involuntary conversion of radio stations arising from wartime restrictions on the purchase and availability of new radio properties.

Under section 1071, gain from the sale or exchange of property may be deferred in cases where the sale or exchange is certified by the Federal Communications Commission to "be necessary or appropriate to effectuate a change in a policy of or the adoption of a new policy by the Commission with respect to the ownership and control of radio broadcasting stations."

This provision has been significantly expanded by the FCC over the last 50 years. First, radio stations were expanded to include television stations. Then television stations were expanded to include cable television; more recently, personal communication services. The newest type of cellular phones have been added.

The policies which the FCC believes warrant the granting of tax breaks also have changed over the years. The original policy of the FCC was to allow tax benefits only in the cases of involuntary conversions of radio stations. In 1978, the FCC announced a new policy of promoting minority ownership of broadcast facilities by offering an FCC tax certificate to those who voluntarily sell such facilities to minority individuals and minority-controlled entities.

The size of transactions receiving tax benefits under section 1071 also has expanded. One proposed transaction recently in the news involves the sale by Viacom of cable television properties for approximately $2.3 billion. The total Federal and State tax benefits for this one transaction could well be in excess of $1½ billion. Clearly, this subcommittee has a responsibility to examine whether a policy which allows a Federal agency to hand out tax benefits of this magnitude is in the taxpayers' interest.

The subcommittee will examine the FCC's 1978 policy to see if it is consistent with the underlying intent of section 1071 or whether the FCC's administration of section 1071 represents the exercise of what can more properly be described as legislative powers.

The subcommittee also will examine whether the tax incentive provided in section 1071 in fact fosters minority ownership of broadcast facilities or whether the FCC policy is a necessary, appropriate means of achieving this goal. The FCC has a number of programs besides the tax break intended to promote diversity in the ownership of broadcast facilities. It is possible these other programs, programs augmented by other changes in the laws regarding the ownership of broadcast stations, would be a better way to promote diversity.

As far as I am concerned, this is not a hearing about the wisdom of promoting diversity. It is an inquiry into whether section 1071, as currently administered by the FCC, is a sensible way of doing so.

With that, I would like to yield to my colleague, Mr. Matsui, for opening comments.

Mr. MATSUI. Thank you very much, Madam Chairman.

I do not think there is any question that the issue of diversity in broadcasting, diversity in ideas, diversity in ownership, is a laudable, important goal of the United States. After all, we are an extremely diverse country. To have a free exchange of ideas on our airwaves is obviously essential for our country to remain unified with common goals, common visions, and common ideals.

I think, also, at the same time, we have to recognize that with the limited pie available in America today, we are already talking about eliminating the Corporation for Public Broadcasting and a number of other very important programs of the Federal Government. We must look at ways of making the system more efficient.

The real issue involved here, I believe, is whether or not using first the Tax Code to try to achieve the laudable goal of diversity in broadcasting is an appropriate vehicle; second, if in fact one should say it is, then what one must ask is whether the section 1071 is a further appropriate way to achieve these goals.

I think the purpose of this hearing will, hopefully, bring that out. I might just further point out that in my discussions with both the Treasury Department, Joint Tax Committee, and FCC, we find that there is a dearth of information available as to whether this program is in fact working. I think it is extremely unfortunate, but as many of you know, back in 1987, the Appropriations Committee, beginning on the Senate side, put in a rider prohibiting the FCC, the Treasury Department, and other agencies of the Federal Government from investigating, analyzing, and determining whether or not this program is working, the amount of benefits that are out as a result of this program, and, more importantly, from making any changes or alterations in this particular program.

As the chairwoman mentioned, this section was originally devised on involuntary transfers back during the wartime period of 1943. The FCC made the decision to expand it. The latest expansions were, as the chairwoman says, in the area of personal communications devices. So this is the first—well, one of the few times that Congress will be analyzing the results of this expansion of this particular section.

Let me also make one further observation. The ostensible reason this issue has come before us today was because of the recent news reports of the Viacom-TCI-Washington transaction that was apparently completed on January 20, 3 days after the press report sent out by Chairman Bill Archer that he wanted to do an investigation of this particular matter.

It is my hope this committee, subcommittee, and the full committee and the Members of the House and Senate, and the President, will make sure that if there are any changes made in the code, it should provide the changes be applied to the transaction that called the matter to our attention.

I have tried to review with some detail this transaction. It is a shame Viacom, TCI, and Mr. Washington are not here to testify today, but, apparently, as I understand, notices have been sent notifying interested parties that they were free to appear and make their case. If they would have come, perhaps we could change our

mind, but until such time, I think that we need to make sure whatever changes we make apply to this particular transaction. They are on notice. There is no constitutional issue involved, as everyone knows.

Let me just, Madam Chairwoman, mention the Viacom transaction. In 1978, Mr. Washington was working for the FCC through the Carter administration. He, among others, devised this particular change to expand the use of section 1071. He has been involved in at least four other tax certificate transactions. Apparently, he still retains ownership interest in many of them.

In this particular transaction, we understand that his investment is anywhere from $1 to $2.3 million out of a $2.3 billion transaction. The total tax benefits, as the chairwoman says, to Viacom, exceed $460 million, because the deferral will be in excess of $1 billion.

That is the issue that we must discuss, whether or not this program works, not only in this case but in other cases, and we must really determine whether this is an appropriate use of taxpayers' money for an obvious laudable goal. So I welcome the chairwoman holding these hearings and I welcome the testimony of the witnesses.

Chairman JOHNSON. Thank you. Just for the record, we did invite Viacom to come and testify. They preferred not to, and I want to submit for the record a letter from Reed Hundt of the FCC that the members will receive shortly.

[The information follows:]

FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON

OFFICE OF
THE CHAIRMAN

January 26, 1995

Honorable Nancy L. Johnson
Chairman
Subcommittee on Oversight of the Committee on Ways and Means
United States Capitol
Washington, D.C. 20515

Dear Chairman Johnson:

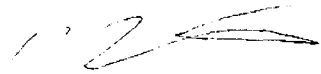
Thank you for inviting me to participate in the Subcommittee's hearing to examine the operation and administration of Internal Revenue Code section 1071, which allows the Commission to grant tax relief with respect to the sales of broadcast and cable facilities to minority buyers. With your indulgence, I will take advantage of the offer in Mr. Mosely's letter and designate the Commission's General Counsel, William E. Kennard, to testify at the hearing. Mr. Kennard, whose written statement is attached, is familiar with the background and operation of the tax certificate program, and will of course be happy to respond to the Subcommittee's questions.

I do want to note in advance of the hearing that statutory language currently in effect forbids the Commission from spending any appropriated funds to "repeal, to retroactively apply changes in, or to continue a reexamination of [its] policies with respect to . . . tax certificates granted under 26 U.S.C. §1071, to expand minority ownership of broadcasting licenses." Departments of Commerce, Justice, and State, the Judiciary, and Related Agencies Appropriations Act, 1995, Pub. L. No. 103-317, 108 Stat. 1724 (1994). Congress has reenacted that language each year since 1987, when it directed the Commission to end a reexamination of minority ownership policies that the Commission had launched in 1986, and told it instead to "apply the policies regarding . . . tax certificates that were in effect before the inquiry commenced." S.Rep. 100-182, p. 76 (1987). See Continuing Appropriations for Fiscal Year 1988, Pub. L. No. 100-202, 101 Stat. 1329 (1987). Ever since, we have had no choice but to apply the tax certificate program as it existed in 1986.

Because of this ongoing statutory constraint on the Commission's discretion in implementing the tax certificate program, the Commission has been unable to subject the program to the kind of reexamination and reassessment that all administrative programs warrant. The Commission, for example, has not had the ability to collect and evaluate facts about the program to the same extent as with other programs in its regulatory jurisdiction.

I want to assure you that the Commission looks forward to cooperating fully with the Subcommittee in responding to questions about the history and current administration of the tax certificate program. Please let me know if, after the hearing, there is any further assistance we can provide.

Sincerely,



Reed E. Hundt

Mr. MCDERMOTT. Madam Chairwoman, will you not take any other opening statements?

Chairman JOHNSON. I can if the subcommittee would like. We do have a long list of witnesses, but I would be happy to yield to the gentleman from Washington.

Mr. MCDERMOTT. I guess I only raise it because I keep wondering why we are zeroing in on this program. I understand there is a large deal that is about to go through or has gone through, according to Mr. Matsui, and the chairman of the committee would like to stop it from happening. But the question I have to ask is are there not some other large tax breaks being brokered even at this very moment that we are having this hearing? It seems to me we are singling out this program while there are many other tax breaks on the books that we should also take a look at.

I have in hand a short list of more than half a dozen special interest tax breaks that are far more generous than this program, and I hope that we are also going to examine those. I hope that the chairwoman will look at taxing capital gains on inherited property, which is worth $20 billion; or reforming estate and gifts taxes, which is $8 billion over the next 5 years; or curbing the excessive depreciation writeoffs, which is $25 billion over the next 5 years; or ending the tax breaks on mergers and acquisitions, which is $9 billion over the next 5 years; or ending tax breaks for runaway plants, which is $1 billion in the next 5 years; or closing gas and oil tax loopholes, which is $7.6 billion.

The question you have to ask yourself is why is this the first thing that comes up? I am waiting to hear the answer. Why this one is—is it just because it was in the paper last week? I think that we ought to get to the bottom of that.

Chairman JOHNSON. Are there other members who would like to make opening statements?

Mr. Herger.

Mr. HERGER. Well, Madam Chair, just very quickly, I just have to ask the question, in response to the gentleman from Washington, did you hear what the Chair and the gentleman from California mentioned? This is pretty major, isn't it? We are talking hundreds of millions of dollars involving one individual. Is the gentleman from Washington questioning the fact that this should be brought up?

Mr. MCDERMOTT. No. No, I am perfectly willing to look at any tax break as long as we do not stop with this hearing on this particular one.

Mr. HERGER. Well, we are early in the session.

Mr. MCDERMOTT. There are a whole lot of other places where we could pick up a whole hell of a lot more money than we are going to pick up in this one, that are more egregious and have gone on for a longer period of time. From my standpoint, when it comes up that it happens to be this kind of deal that makes the first one out of the block, to me, that raises real questions about what is happening here.

Chairman JOHNSON. I would like to correct for the record the gentleman's comment that this chairman would like to stop it from happening. The chairman did not say she would like to stop it from happening.

In fact, in my opening comments I said, clearly, this subcommittee has the responsibility to examine whether a policy that allows a Federal agency such a free hand to hand out tax benefits of this magnitude is in the public's interest. That is the question before us.

Second, I regret the gentleman was not at the meeting of the Oversight Subcommittee, the bipartisan meeting, at which we reviewed our agenda because some of the things he suggested he could have offered at that time. We do have a full agenda. We will certainly be looking at many things, and we will be happy to add those things to the agenda as well.

Mr. MCDERMOTT. If the Chair would yield for 1 second, I was referring to the chairman of the full committee; I was not referring to you, who wants to stop this.

Chairman JOHNSON. Well, your reference appeared to refer to me.

Mr. MCDERMOTT. I was not precise.

Chairman JOHNSON. I have no indication from the chairman that he is interested in anything more than the exploration that I have been tasked to carry out for the oversight function, which is exactly what government ought to be doing: overseeing the way the law is being implemented and that is what we are doing here today.

Mr. HANCOCK. Madam Chair.

Chairman JOHNSON. Mr. Hancock.

Mr. HANCOCK. Just a real quick statement. There is a major difference between a $400 million tax credit to one corporation, than a $400 million or $1 or $10 billion that is spread out over thousands of people. There is a major difference.

Chairman JOHNSON. Mr. Kies, would you proceed, please.

STATEMENT OF KENNETH J. KIES, CHIEF OF STAFF, JOINT COMMITTEE ON TAXATION, ACCOMPANIED BY MARY SCHMITT, DEPUTY CHIEF OF STAFF

Mr. KIES. Thank you, Madam Chairwoman.

I am accompanied today by Mary Schmitt, the Deputy Chief of Staff of the Joint Committee on Taxation. It is my pleasure to present the testimony of the staff of the Joint Committee on Taxation to this subcommittee on the Federal Communications Commission tax certificate program.

My testimony will be in four parts. First, I will provide a brief overview of the Internal Revenue Code section 1071 issues; second, I will describe the legislative background of section 1071 and the FCC tax certificate program; third, I will describe the application of the tax rules in those cases where an FCC tax certificate is granted; and, fourth, I will describe briefly some of the tax policy issues the subcommittee may wish to consider in assessing section 1071.

Under present law, a taxpayer generally is required to include in gross income the gain recognized upon the sale or disposition of a business, including a broadcast business. An exception to this general rule under section 1071 provides that a seller of certain property who receives a tax certificate from the FCC may defer the recognition of gain on the sale indefinitely by either electing to purchase replacement property within 2 years after the taxable year

in which the sale occurs, or electing to reduce the basis of depreciable property held by the seller immediately after the sale. The deferred gain may be recognized upon subsequent disposition, if any, of the replacement properties.

Section 1071 was originally enacted in 1943 to facilitate the sale of properties required to be disposed of because of certain prohibitions on ownership of multiple stations within the same market. The tax certificate program has been modified and expanded a number of times.

In 1978, the FCC announced a policy of promoting minority ownership of broadcast facilities by offering an FCC tax certificate to those who voluntarily sell such facilities to minority-owned or controlled entities. The FCC's policy was based on the view that minority ownership of broadcast stations would provide a significant means of fostering the inclusion of minority views in programming thereby serving the needs and interests of the minority community.

The FCC subsequently expanded its policy to include the sale of cable television in 1993. The FCC further expanded the program to apply to personal communication services. Minorities within the meaning of the FCC policy include "blacks, Hispanics, American Indians, Alaskan Natives, Asian and Pacific Islanders."

As a general rule, a minority-controlled corporation is one in which more than 50 percent of the voting stock is held by minorities. A minority-controlled partnership is one in which the general partner is a minority or minority-controlled and minorities have at least a 20 percent interest in the partnership.

The FCC requires those who acquire broadcast properties with the help of the FCC tax certificate policy to hold those properties for at least 1 year. An acquisition can qualify if there is a preexisting agreement to buy out the minority interest at the end of the 1-year holding period.

In 1982, the FCC further diversified or further expanded its tax certificate policy for minority ownership. At that time the FCC decided that in addition to those who sell properties to minorities, investors who contribute to the stabilization of the capital base of a minority enterprise would be entitled to a tax certificate upon the subsequent sale of their interest in a minority entity.

Some recent news reports suggest that FCC tax certificates are not fostering real minority ownership of broadcast stations. In some instances, a minority investor purports to control the buyer often through a limited partnership or other syndication, but effectively does not because of the small economic interest of the minority investor. In other instances, minority buyers are reported to have resold the broadcast properties shortly after their original sale.

The FCC tax certificate program functions as an open-ended tax expenditure with the FCC as the authorizing agency. Since 1978, the FCC has issued 378 certificates under section 1071, 317 of which relate to the sale of broadcast properties to minority-owned or controlled buyers. The staff of the Joint Committee previously estimated that the tax expenditure relating to Code section 1071 over 5 fiscal years was $500 million; however, it is in the process of reviewing this estimate in light of new information it is receiv-

ing. The Treasury Department has estimated the tax expenditure at $1.6 billion for the same period.

Code section 1071 was originally enacted in 1943, as I indicated. Congress believed that the involuntary conversion rules at the time were inadequate and expanded those rules in the case of the sales of these properties due to the fact there was a lack of availability of radio stations for replacement properties at the time.

Apart from the FCC tax certificate program, there are other programs administered by the FCC to foster minority ownership. The FCC awards comparative merit in licensing proceedings to minority applicants in the interest of promoting minority entrepreneurship.

In addition, the FCC's distressed sale policy allows broadcasting licensees, whose licenses have been designated for a revocation hearing, prior to the commencement of a hearing to sell their station to a minority-owned or controlled entity at a price substantially below fair market value. The licensee, whose license has been designated for hearing, would ordinarily be prohibited from selling, assigning, or otherwise disposing of its interest until the issues have been resolved in the licensee's favor.

On January 20, 1995, Viacom and Mitgo, wholly owned by Frank Washington, and affiliates of InterMedia Partners, announced they had signed a definitive agreement under which Viacom will sell its cable systems serving 1.1 million customers to a partnership, of which Mitgo is the general partner, for approximately $2.3 billion in cash. A subsidiary of TeleCommunications Inc. is one of the limited partners of InterMedia. Recent news reports suggest that TeleCommunications will provide "nearly all" of the money for the cable system purchase. Mr. Washington will invest approximately $1 million of his own money according to recent reports. Mr. Washington is an African-American and apparently controls Mitgo for FCC purposes, which will be the general partner for the partnership acquiring the cable systems.

The sale is subject to customary conditions, approvals of local franchise authorities, and receipt of the FCC tax certificate. Viacom has said the proceeds from the transaction, which it expects to complete in the second half of this year, will be used to repay debts.

As designed, the sale appears to meet the standards articulated by the FCC to qualify for a tax certificate under section 1071, even though the actual investment by Mr. Washington may be as little as $1 million. News reports and other publicly available information indicate that the deferred gain on the Viacom sale can be reasonably expected to be in the range of $1.1 to $1.6 billion.

The tax deferral, including State tax benefits, would be in the range of $440 to $640 million.

Under generally applicable Code provisions, the seller of a broadcast business, or any other business, recognizes gain to the extent the sale price exceeds the seller's basis in the property. Under Code section 1071, a seller receiving a tax certificate can defer recognizing the gain on the sale indefinitely by making either one or a combination of two elections.

The seller may elect to treat the sale or exchange as an "involuntary conversion." If this election is made, the taxpayer will generally avoid recognizing gain on the sale to the extent it reinvests

the sale proceeds in qualifying replacement properties within 2 years from the end of the tax year in which the sale occurs.

The IRS has issued private letter rulings holding that purchasing stocks or assets from a related party can qualify as replacement properties. Thus, it appears that in certain circumstances, related taxpayers may obtain significant tax deferral without any additional cash outlay to acquire new properties after a qualifying FCC tax certificate sale. The involuntary conversion election could provide greater flexibility as to the allocation of reduced basis than the alternative election to reduce the basis of depreciable property.

Let me just briefly review some of the tax policy issues raised by section 1071 and then I would be happy to take any questions.

Based upon our review of Code section 1071, and the manner in which it is administered by the FCC and the IRS, there are a number of tax policy considerations which we have identified and which the subcommittee may wish to take into consideration in reviewing what, if any, changes should be made to this provision. They are as follows:

First, the current law provision extends broad discretionary authority to an agency of the Federal Government to administer a tax provision which is substantially open-ended. The recent expansion of the program to personal communications service licenses is evidence of its open-ended nature. We have been unable to identify any other aspect of the Internal Revenue Code, other than the provision which grants the State Department the authority to designate combat zones, which extends this kind of discretionary authority.

Second, the manner in which the FCC administers this provision does not take into account the tax cost associated with granting an FCC tax certificate. Indeed, we have been advised that the FCC does not request the information as part of its tax certificate application program. As a result, there is no effort made to balance the cost to the Federal Government in the form of lost tax revenues with the benefit which is obtained from the granting of the FCC tax certificate.

Third, there is no cap on the amount of tax benefit which accrues on a per transaction basis. This raises concerns, particularly when considering a transaction like the proposed Viacom transaction, which appears to have the ability to confer a substantial tax benefit in the range of $440 to $640 million if it were to receive an FCC tax certificate. In addition, there is no requirement that the tax benefit accrue, in whole or in part, to the minority-owned or minority-controlled purchaser. In many transactions it is possible that the minority-owned or controlled purchaser is paying full fair market value for the property acquired even though the seller may be receiving a substantial tax benefit over and above the sale price for the broadcast property.

Fourth, it appears that as a result of IRS interpretation, the sellers of property qualifying for the FCC tax certificate may be able to utilize various planning techniques that enable them to obtain a tax deferral indefinitely without reducing the basis of existing properties or being forced to acquire new properties from unrelated third parties.

Fifth, the manner in which the FCC has administered section 1071 appears to allow transitory ownership by minority parties and ownership of very small actual interests in properties qualifying for the FCC tax certificate.

Sixth, programs like this one have typically been administered through the appropriation of direct spending amounts so that the Congress can have continuing oversight over the amount of money which is being spent for a particular program. As a result, Congress may wish to substitute a direct appropriation for section 1071.

These are all issues which the subcommittee needs to consider in assessing the merits of the current law and any proposed changes. I would be happy to take any questions that you might have.

Thank you.

[The prepared statement follows:]

STATEMENT OF KENNETH J. KIES, CHIEF OF STAFF JOINT COMMITTEE ON TAXATION

Thank you Madam Chairwoman. It is my pleasure to present the testimony of the Staff of the Joint Committee on Taxation at this hearing of the Oversight Subcommittee on the Federal Communications Commission's tax certificate program. My testimony will be in four parts: first, I will provide a brief overview of Internal Revenue Code section 1071 issues; second, I will describe the legislative background of section 1071 and the FCC tax certificate program; third, I will describe the application of the tax rules in those cases where an FCC tax certificate is granted; and fourth, I will briefly describe some of the tax policy issues the Committee may wish to consider in assessing section 1071.

Overview

Under present law, a taxpayer generally is required to include in gross income the gain recognized upon the sale or disposition of a business, including a broadcast business. An exception to this general rule under Code section 1071 provides that a seller of certain property who receives a tax certificate from the FCC may defer the recognition of gain on the sale indefinitely by either (1) electing to purchase replacement property within 2 years after the taxable year in which the sale occurs or (2) electing to reduce the basis of depreciable property held by the seller immediately after the sale or acquired by the seller in the taxable year of the sale. The deferred gain may be recognized upon the subsequent disposition, if any, of the replacement property. The purchaser of a broadcast business, whether or not pursuant to a tax certificate program, acquires a basis in the business equal to the purchase price paid, which may be eligible for depreciation or amortization deductions. The tax benefit provided by Code section 1071 is the ability to defer, in some cases permanently, what would otherwise be a current tax payment to later years. A long-term or indefinite deferral can constitute the equivalent of complete tax forgiveness.

Code section 1071 was originally enacted in 1943 to facilitate the sales of properties required to be disposed of because of certain prohibitions on ownership of multiple radio stations within the same market. This tax certificate program has been modified and expanded a number of times.

Minority ownership policy

In 1978, the FCC announced a policy of promoting minority ownership of broadcast facilities by offering an FCC tax certificate to those who voluntarily sell such facilities (either in the form of assets or stock) to minority-owned or controlled entities. The FCC's policy was based on the view that minority ownership of broadcast stations would provide a significant means of fostering the inclusion of minority views in programming, thereby serving the needs and interests of the minority community as well as enriching and educating the non-minority audience. The FCC subsequently expanded its policy to include the sale of cable television systems. In 1993, the FCC further expanded the program to apply to personal communication services. The FCC is in the process of auctioning 2,000 of these licenses.

"Minorities," within the meaning of the FCC's policy, include "Blacks, Hispanics, American Indians, Alaska Natives, Asians, and Pacific Islanders." As a general rule, a minority-controlled corporation is one in which more than 50 percent of the voting stock is held by minorities. A minority-controlled limited partnership is one in which the general partner is a minority or minority-controlled, and minorities have at least a 20-percent interest in the partnership. The FCC requires those who acquire broadcast properties with the help of the FCC tax certificate policy to hold those properties for at least one year. An acquisition can qualify even if there is a pre-existing agreement (or option) to buy out the minority interest at the end of the one-year holding period, provided that the transaction is at arms-length.

In 1982, the FCC further diversified its tax certificate policy for minority ownership. At that time, the FCC decided that, in addition to those who sell properties to minorities, investors who contribute to the stabilization of the capital base of a minority enterprise would be entitled to a tax certificate upon the subsequent sale of their interest in the minority entity.[1] Since 1987, in appropriations legislation, the Congress has prohibited the FCC from using any of its appropriated funds to repeal, to retroactively apply changes in, or to continue a reexamination of its comparative licensing, distress sale and tax certificate policies. This limitation has not prevented an expansion of the existing program.

Some recent news reports suggest that FCC tax certificates are not fostering "real" minority ownership of broadcast stations. In some instances, a minority investor purports to control the buyer (often through a limited partnership or other syndication) but effectively does not because of the small economic interest of the minority investor. In other instances, minority buyers are reported to have resold the broadcast property (or their interest in the property) shortly after the original sale.

The FCC tax certificate program functions as an open-ended tax expenditure with the FCC as authorizing agency. Since 1978, the FCC has issued 378 tax certificates under Code section 1071, 317 of which related to the sale of broadcast properties to minority-owned or minority-controlled buyers. The staff of the Joint Committee on Taxation previously has estimated the tax expenditure

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[1] To qualify for an FCC tax certificate in this circumstance, an investor must either (1) provide start-up financing that allows a minority to acquire either broadcast or cable properties, or (2) purchase shares in a minority-controlled entity within the first year after the licenses necessary to operate the property is issued to the minority. In these situations, the status of the divesting investor and the purchaser of the divested interest is irrelevant, since the goal is to increase the financing opportunities available to minorities.

relating to Code section 1071 to be $500 million over the five fiscal years 1995-1999, although it is in the process of reviewing this estimate in light of new information it is receiving. The Treasury Dpartment has estimated the tax expenditure at $1.6 billion over the same period.

Legislative Background

Code section 1071 was originally enacted as part of the Revenue Act of 1943 to help the FCC implement a new policy that prohibited licensees from owning more than one radio station per market. Congress believed that the involuntary conversion rules (which generally permitted gain on sales to be excluded from taxable income if the proceeds of a sale were reinvested in property similar to the property involuntarily converted) should be applied to these transactions but needed to be liberalized for the FCC-ordered sales because, "[d]ue to wartime restrictions, the purchase of new radio property [would have been]... difficult."

The term "radio broadcasting" was expanded to include cable television in 1973. The use of FCC tax certificates was recently expanded in connection with the auction of personal communication services.

Other FCC minority ownership programs

Apart from the FCC tax certificate program, there are other programs administered by the FCC to foster minority ownership. The FCC awards comparative merit in licensing proceedings to minority applicants in the interest of promoting minority entrepreneurship. In addition, the FCC's distress sale policy allows broadcasting licensees whose licenses have been designated for revocation hearing, prior to the commencement of a hearing, to sell their station to a minority-owned or controlled entity, at a price "substantially" below its fair market value. A licensee whose license

has been designated for hearing would ordinarily be prohibited from selling, assigning or otherwise disposing of its interest, until the issues have been resolved in the licensee's favor.

Viacom transaction

On January 20, 1995, Viacom Inc. (a publicly-traded company) and Mitgo Corp., a company wholly owned by Frank Washington, and affiliates of InterMedia Partners announced that they had signed a definitive agreement under which Viacom will sell its cable systems serving 1.1 million customers to a partnership, of which Mitgo is the general partner, for approximately $2.3 billion in cash. A subsidiary of TeleCommunications Inc. (a national cable television operator) is one of the limited partners of Intermedia. Recent news reports suggest that TeleCommunications Inc. will provide "nearly all" of the money for the cable system purchase. Mr. Washington will invest about $1 million of his money. Mr. Washington is an African American and apparently controls Mitgo for FCC purposes, which will be the general partner for the partnership acquiring the cable systems.

The sale is subject to customary conditions, approvals of local franchise authorities and receipt of an FCC tax certificate. Viacom said proceeds from the transaction, which is expected to be completed in the second half of 1995, will be used to repay debt.

As designed, the sale appears to meet the standards articulated by the FCC to qualify for a tax certificate pursuant to Code section 1071 even though the actual investment by Mr. Washington may be as little as $1 million. News reports and other available information indicate that the deferred gain on the Viacom sale can be reasonably expected to be in the range of $1.1 billion to $1.6 billion.

Application of Tax Rules

Under generally applicable Code provisions, the seller of a broadcast business, or any other business, recognizes gain to the extent the sale price (and any other consideration received) exceeds the seller's basis in the property. Under Code section 1071, a seller receiving a tax certificate from the FCC can defer recognizing gain on the sale indefinitely by making either one or a combination of two elections on its tax return for the year of the sale.

The seller may elect to treat the sale or exchange as an "involuntary conversion" under Code Section 1033. If this election is made, the taxpayer will generally avoid recognizing gain on the sale to the extent that it reinvests the sale proceeds in qualifying replacement property within two years from the end of the tax year in which the sale occurs. If the taxpayer sells assets rather than stock, it may be required to recapture depreciation under certain circumstances.

Qualifying replacement property, within the meaning of this section of the Code, includes the following:

(1) Stock of corporations operating "radio broadcasting stations" (a term that the Internal Revenue Service ("IRS") interprets as including television stations and cable television stations). The seller may purchase any number of shares of a broadcast corporation, including a publicly-traded company (and may invest in more than one broadcast company).

(2) Assets "similar or related in service or use" to the property sold.

Under the "involuntary conversion" election and the general involuntary conversion rules, the taxpayer's basis in the acquired replacement property will generally be the "carryover" basis of the property that was sold, rather than a fair market value basis reflecting the full reinvested proceeds. If the replacement property is stock of a corporation conducting a qualifying business,

the carryover basis would apply to the stock but generally would not change the basis of assets inside the corporation. Depending on the basis and remaining depreciable lives of the assets inside the corporation, this might result in significant deferral of any tax detriment resulting from the carryover basis, as long as the stock is not sold.

The IRS has issued private letter rulings holding that the purchase of stock or assets from a related party can qualify as a replacement purchase. Thus, it appears that in certain circumstances related taxpayers may obtain significant tax deferral without any additional cash outlay to acquire new properties after a qualifying FCC tax certificate sale. The involuntary conversion election could provide greater flexibility as to the allocation of reduced basis than the alternative election to reduce basis of depreciable property.

If the seller chooses not to purchase "replacement property" or would otherwise recognize gain (because it reinvested only a portion of its cash proceeds in qualifying replacement property), Code section 1071 allows the seller to elect not to recognize the gain to the extent it is applied to reduce the basis of depreciable property (within the meaning of Code section 167) that is either held by the seller immediately after the sale or acquired by the seller in the taxable year of the sale. Eligible property includes most tangible property (not just broadcast property), but does not usually include items such as inventories, stock in trade, and securities. Eligible property also includes goodwill and other intangible property that is depreciable under Code section 197 (which generally applies to intangible property acquired after August 10, 1993). A seller that elects to reduce its basis in depreciable property must reduce its basis in all of its depreciable property by reference to a regulatory formula--it cannot allocate the reduction disproportionately unless authorized by the IRS to do so.

Issues Raised by Code Section 1071

Based upon our review of Code 1071, and the manner in which it is administered by the FCC and the Internal Revenue Service, there are a number of tax policy considerations which we have identified and which the Committee may wish to take into consideration in reviewing what, if any, changes should be made to this provision. These considerations are as follows:

- First, the current law provision extends broad discretionary authority to an agency of the Federal government to administer a tax provision which is substantially open-ended. The recent expansion of the program to personal communication service licenses is evidence of its open-ended nature. We have been unable to identify any other aspects of the Internal Revenue Code, other than the provision which grants the State Department the authority to designate combat zones, which extends this kind of discretionary authority.
- Second, the manner in which the FCC administers this provision does not take into account the tax cost associated with the granting of an FCC tax certificate. Indeed, we have been advised that the FCC does not request this information as part of its tax certificate application program. As a result, there is no effort made to balance the cost to the Federal government with the benefit which is obtained from the granting of an FCC tax certificate.
- Third, there is no cap on the amount of tax benefit which accrues on a per transaction basis. This raises concerns, particularly when considering a transaction like the proposed Viacom transaction, which appears to have the ability to confer a substantial tax benefit in the range of $440 million to $640 million if it were to receive an FCC tax certificate. In addition, there is no requirement that the tax benefit accrue, in whole or in part, to the minority-owned or controlled purchaser. In many transactions it is possible that the minority-owned or

controlled purchaser is paying full fair market value for the property acquired even though the seller may be receiving a substantial tax benefit over and above the sale price for the broadcast property.

- Fourth it appears that as a result of IRS interpretation, the sellers of property qualifying for the FCC tax certificate can utilize various planning techniques that enable them to obtain a tax deferral indefinitely without reducing the basis of existing properties or being forced to acquire new properties with a reduced basis.
- Fifth, the manner in which the FCC has administered Code section 1071 appears to allow transitory ownership by minority parties and ownership of very small actual interests in properties qualifying for the FCC tax certificate.
- Sixth, programs like this one have typically been administered through the appropriation of direct spending amounts so that Congress can have continuing oversight over the amount of money which is being spent for the particular program. As a result, Congress may wish to substitute a direct appropriation program for Code section 1071.

These are all issues which the Committee needs to consider assessing the merits of current law and any changes that may be necessary. I will be happy to take questions.

Chairman JOHNSON. Thank you, Mr. Kies.

In regard to the Viacom transaction, to what extent has the purchase price to the purchaser been reduced to reflect a tax benefit which Viacom will enjoy if it receives an FCC tax certificate?

Mr. KIES. Well, it is difficult to know exactly because we do not have all the details on the transaction. However, in discussions with experts in the cable industry, we have been advised that typically the fair market value of cable properties is determined as a multiple of cash-flow.

In the case of Viacom, based on SEC documents, it appears that the cash-flow—net cash-flow from the cable properties—is in the neighborhood of $110 to $150 million per year. At 10 times cash-flow on the upper end, that would suggest a fair market value of $1.5 billion. The cash purchase price here is $2.3 billion. That would tend to suggest that Viacom is receiving at or above fair market value without regard to the tax benefits.

If that is the case, then it would not appear that the tax benefit is in any way benefiting the minority-controlled purchaser, just based on that analysis.

Chairman JOHNSON. So normally the sale price is 10 times cash-flow, roughly? In this case it is 15 to 20 times cash-flow?

Mr. KIES. It is in that neighborhood in this particular transaction.

Chairman JOHNSON. So there does not appear to be any benefit to the purchaser of the tax certificate?

Mr. KIES. Based on that analysis, no.

Chairman JOHNSON. Second, under section 1071, the seller is required to reinvest the proceeds of gain which are not subject to tax within a 2-year period or to reduce basis in existing properties. For those taxpayers who elect to reinvest the proceeds in existing properties, are they forced to reduce basis in those assets and, thus, give up some of the benefit of those assets?

In other words, since they got a great big benefit through the FCC certificate and are required to reinvest it, are they then required to give up some other benefit that they already have as they do that reinvestment process?

Mr. KIES. That is the general rule, although, as I alluded to in my testimony regarding the replacement property requirement, the IRS has ruled that a taxpayer can purchase the replacement property from a related party. As a consequence, it is possible, and it appears that because there have been a number of IRS rulings issued regarding this issue, that an entity would purchase replacement property from within its own consolidated group. If that were the case, for example, if a taxpayer purchased stock in a subsidiary, there might not be a reduction in basis of the assets subject to depreciation.

I might just say, though, even if there is a reduction in basis of assets, there is still a substantial tax benefit because the reduction in basis of assets causes a loss of depreciation that takes place over a long period of time, whereas the tax deferral occurs all in the first year. So there is still substantial benefit to the seller even if there is a reduction of basis.

Chairman JOHNSON. Thank you, Mr. Kies.

We have a large and inquisitive subcommittee, so I am going to defer the rest of my questions and we will go through the membership once. We will use the timeclock and then if there are further questions, since this is such an important matter, we will try briefly with a second round of questions.

Mr. Matsui.

Mr. MATSUI. Thank you, Madam Chairwoman.

Mr. Kies, you indicated in your brief or your report that the total tax loss over the next 5 years could be up to $500 million. The Treasury Department has said that the total tax loss could be in excess of $1.6 billion over the next 5 years. I notice that in your addendum you mention that there may be further information that might result in a higher number.

Can you tell me whether you have reestimated this; and second, what that number is if you have reestimated this?

Mr. KIES. Mr. Matsui, we have not reestimated it yet. I can describe some of the additional information that is coming to our attention.

Mr. MATSUI. Let us do this. Perhaps you can get for the subcommittee and the full committee, after you have done your analysis quickly, I hope, what your view of the total tax loss will be to the Federal Treasury over the 5-year period with the additional information you have received.

Mr. KIES. We will be doing that.

Mr. MATSUI. Because we will need that obviously for whatever changes, if we make any in order.

[The following was subsequently received:]

#95-1 090
30-Mar-95

ESTIMATE OF FEDERAL TAX EXPENDITURE FOR INTERNAL REVENUE CODE SECTION 1071

Fiscal Years 1996 - 2000

[Billions of Dollars]

Provision	1996	1997	1998	1999	2000	1996-00
1. Deferral of gains from sales of broadcasting facilities to minority-owned businesses	0.2	0.4	0.4	0.4	0.4	1.8
NET TOTALS	**0.2**	**0.4**	**0.4**	**0.4**	**0.4**	**1.8**

Joint Committee on Taxation

NOTE: Details may not add to totals due to rounding.

Mr. MATSUI. Mr. Washington invested, according to news reports, anywhere up to $1 to $2.3 million. I understand maybe the $1.3 additional million is his obligation, his debt obligation, although no one really seems to have that information.

The total transaction is $2.3 billion. Now, Mr. Washington has in excess of a 20-percent interest; that qualifies him as a minority participant.

What are the rules—in other words, can somebody invest $10 or $20, and as long as his partnership interest is in excess of 20 percent, he will then be able to qualify? Is this an equity interest? In other words, will he have $400 million gain out of this with the $1 million investment? How does this work?

Mr. KIES. The reason you can have a relatively small investment but still have what qualifies as a 20-percent equity interest in the partnership is that the other investors who have put in the $2.3 billion probably are receiving what is referred to as a guaranteed payment or a guaranteed return. So they stand ahead of the profits interest. The 20-percent interest represents an interest in profits after the return to the $2.3 billion contribution by the investors.

Mr. MATSUI. So it is not an equity interest he acquires with this $1 or $2.3 million investment?

Mr. KIES. It is not an equity interest in the sense that you would normally think of 20 percent of the $2.3 billion. I think it is a safe bet that the people putting in the $2.3 billion are not going to let $400 million go out for the $1 million investment.

The answer to the first part of your question, whether or not you can put $10 in. We believe that an investor could put in what is referred to as sweat equity, which is his or her intention to work on the property and receive back a 20-percent equity interest under those circumstances.

Mr. MATSUI. I would find that much more palatable, if in fact he did not own four other businesses, two of which were with Jack Kent Cook. I understand Jack Kent Cook cannot be one of the easier persons to work with. So it would be my opinion that in fact he put in a lot of sweat equity. I don't know how he could manage to do it.

One last question, and I know other members have questions.

Could you tell me of the 317 such transactions with minority participants, the lengths of time in which the minority participants held on to the contract? You said under the 1071 rules they must exceed at least 12 months. Do we have any information on that? Do we have any information as to whether these 317 purchases resulted in a diverse set of ideas or diverse set of programming?

Is there any information that would show us what the result of all this effort has been in terms of achieving our goals of diversity, of minority participants and, second, in achieving our goals of diverse programming? I ask that because I am assuming that Mr. Washington—of the 317, 4 are his, so it is one ownership. So we cannot really tell if there are 317 new minority contractors out there. There may be a number, but there could be much less than that if there are a lot of transactions that one or two people have.

Mr. KIES. The information is a little bit spotty. There is a variety of witnesses who are going to testify about some of that, some of

whom will tell you they own 100 percent of these properties and have owned them for a long period of time.

Mr. MATSUI. That is what we really want out of this, but some of the information provides otherwise, but go ahead.

Mr. KIES. Some clearly have not been held or they have been held for a transitory period. In terms of the effect of the program, the one statistic we do have is since 1978 when the program was put into effect, the minority-owned or controlled properties increased from, I think it was 0.5 to 2.9 percent. It is not possible to determine to what extent this program is responsible for that because the FCC does have other programs that play a role.

I think some of the witnesses will, and some of the scholarly pieces that have been written on this program suggest some skepticism as to how much it has impacted programming.

Mr. MATSUI. If I may just ask one further followup to that question, then. As far as these contractors are concerned, you do not have that information now. Is that because of the appropriation rider which prohibits any analysis or any reexamination of this program?

Mr. KIES. We have asked the FCC for information on the 317 deals that have been done. We have received some of it. Some of it is archived. In some cases, information from the IRS has been destroyed under their record disposition program. So we are in the process of trying to learn more about some of the things you have talked about. We had a limited amount of time to get ready.

Mr. MATSUI. Because you are not under this prohibition, it is the FCC, Treasury, and IRS.

Mr. KIES. That is correct.

Mr. MATSUI. So whatever information they provide you as raw data, it cannot be through a study or investigation?

Mr. KIES. That is correct.

Mr. MATSUI. Thank you.

Chairman JOHNSON. Thank you.

Mr. Herger.

Mr. HERGER. Thank you, Madam Chair.

Thank you very much for your testimony, Mr. Kies.

Let me see if I understand this: the policy was originally set up to help minorities become at least minority owners or owners within these types of enterprises. Let me see if I understand this particular case. Is it right, as far as the cost benefit, that the taxpayers are paying $400-plus million in this situation for a minority to own an interest for perhaps 1 year or less?

Mr. KIES. Well, in the case of the Viacom transaction, we do not know how long Mr. Washington plans to stay in the transaction. But we do know from a variety of reports that the amount of his investment is relatively small.

I want to clarify one thing. Our analysis of the total tax costs between $440 and $640 million also takes into account that States generally piggyback the Federal tax system for purposes of determining State tax liability. We have assumed an average State tax rate of 5 percent. So there is a State tax revenue loss in addition to the Federal revenue loss and that leads to the analysis of $440 to $640 million.

Mr. HERGER. These numbers are so large, it is hard to believe what we are hearing. In this one individual, to bring one individual and a minority member, we are talking about between State, and you mentioned this does have ramifications as far as State governments, who piggyback, but we are talking about taxpayers somewhere are having to make up for the $600 million for as little as 1 year of ownership in this one minority; is that correct?

Mr. KIES. That is basically correct. It is a substantial amount.

Mr. HERGER. I cannot believe anyone ever set up this program to work like this, and, Madam Chair, whether it was you or the chairman of the committee, I want to thank you for bringing this to our attention and having a hearing on this. If this situation can happen here, it undoubtedly can happen in other situations, and we certainly have to make a change and I thank you.

Chairman JOHNSON. Thank you. Mr. Hancock.

Mr. HANCOCK. Thank you, Madam Chairwoman.

In your testimony you mention that since 1978 the FCC has issued 378 tax certificates under this Code section; and then on the appendix table one, you show the numbers here.

Can we get further documentation of these various transactions? In other words, the total amounts of money of tax certificates that have been issued, how many times names are duplicated? Is it potentially a little select group of people that are familiar with this that have been using it over and over? Do we have that information? Can we get it documented?

Mr. KIES. Mr. Hancock, we have some information because we did get from the FCC copies of a number of the certificates that have been issued. But those tend to be relatively short, a two-page letter that says this transaction qualifies and it typically does not include the purchase price or any financial information.

We are in the process of asking the FCC for additional information so that we can do a little better analysis in terms of the dollar volume of the transactions and whether or not, for example, there have been multiple transfers of the same properties in these types of transactions.

So we are in the process of trying to gather that information right now.

Mr. HANCOCK. How long have you been trying to get this information?

Mr. KIES. We have been working on this for about 2 weeks now, and we have met with the FCC and they have been trying to pull it together. I think it is a fairly large amount of documentation that needs to be delivered to us.

Mr. HANCOCK. OK. Well, thank you very much. I will ask the same questions of the next panel.

Thank you.

Chairman JOHNSON. Thank you. Mr. Cardin.

Mr. CARDIN. Thank you, Madam Chairman.

Ken, there are several things that concern me about section 1071. You have brought out the economics. But let me talk about the tax policy being controlled by an independent agency rather than by the Treasury or Congress or the Internal Revenue Service.

Is it your testimony that you can only find one other similar provision to this, which is the State Department declaring a war zone? That is the only other comparable provision?

Mr. KIES. That is the only provision we found where there is a giving away of substantial discretion to actually implement a tax provision. The States have some role, for example, in administering low-income housing credits, but the terms under which you can issue low-income housing credits are fairly defined in the code. So they are just administering the code.

The difference with 1071 is that the words of 1071 literally say that the FCC can implement any current or future policy that it adopts through the issuance of tax certificates, and that degree of discretion does not exist anywhere else that we are aware of.

Mr. CARDIN. During the 50-year history of this section, has there been any evidence of Treasury being directly involved with FCC in setting up how these certificates should be issued?

Mr. KIES. I think the Treasury representatives are going to testify later. I think they will tell you that basically they pretty much accept whatever the FCC issues as conferring the tax benefit because of the open-ended nature of the statutory provision. So I do not think there has been much in the way of Treasury or IRS involvement.

The only extent to which they have been involved, and I think it has been in conjunction with the FCC, is when the provision has been expanded. It originally applied to radio properties and then was expanded to television and cable and now to these personal communications services. But other than that, I think Treasury's involvement has been relatively modest.

Mr. CARDIN. There are other provisions in the Internal Revenue Code that deal with forced transactions and deal with minority preferences, and in those cases, if I understand correctly those provisions, there are Treasury regulations and IRS administrations who carry out certain policies. Are you aware of any effort made on this section of the code to adopt or to work with Treasury or IRS to see if there is some consistency in policy?

Mr. KIES. I am not aware. Again, the Treasury and FCC representatives are probably in a much better position to respond to that, but at least the information we have gathered to date indicates that Treasury and IRS have had a relatively hands-off involvement.

Mr. CARDIN. So that if the FCC issues the certificate, it is fairly well accepted? It is never challenged by Treasury and the taxpayer gets the break and there is no ability of Treasury to use their normal enforcement mechanisms to see whether the goals or regulations are being complied with?

Mr. KIES. That is correct.

Mr. CARDIN. Now, let me just see if I understand how the tax provisions work. The seller gets the tax certificate and can, therefore, defer the tax or avoid the tax by reinvesting the proceeds in other entities. If the taxpayer chooses that course, then there is no reduction in the basis. We get a stepped-up basis on the properties. The buyers would get the stepped-up basis?

Mr. KIES. Let me explain that and just take a quick simple example.

If I have a property that has a tax basis of $10 million and I sell it for $50 million, the buyer gets the stepped-up basis to $50 million. Under current law—intangibles legislation, which was enacted a couple of years ago—that taxpayer would be amortizing most of that basis over a 15-year period.

The seller has a deferred $40 million gain. If the seller chooses the route of buying replacement property, the seller, when it buys that replacement property, gets a basis of only $10 million in the replacement property. However, as I pointed out in my testimony, it is possible that you can buy within your own consolidated group. If you were to buy stock within your own consolidated group, it is possible that the basis reduction would only affect the stock basis and not the inside basis of the assets that would still be depreciated in their regular course.

But if you go outside and buy a replacement property from an unrelated third party, you only get a basis of $10 million. So you get a lower basis for depreciation.

Mr. CARDIN. But the buyer would get the full basis; the stepped-up basis?

Mr. KIES. The buyer gets the stepped-up basis; correct.

Mr. CARDIN. In this case it would be based upon the 2.3—in the Viacom deal it would be based upon the $2.3 billion price?

Mr. KIES. That is correct.

Mr. CARDIN. Then if the neutral cost recovery were to go into effect, it could take advantage of the neutral cost recovery on $2.3 billion. I am just trying to figure out another reason to be opposed to the neutral cost recovery.

Mr. KIES. No comment.

Chairman JOHNSON. Mr. Ramstad.

Mr. RAMSTAD. Thank you, Madam Chair.

I think we would all agree that the intent of the minority tax certificate program from a policy standpoint is a worthy one. Certainly, we all want to increase minority influence in broadcasting, but I also think that it would be specious to argue if the minority involved in the program has no direct management of the purchased property, that that worthwhile policy objective is not attained.

My question is this, Mr. Kies: What constitutes an acceptable level of minority ownership to qualify for the tax certificate program?

Mr. KIES. Well, in the case of an entity that is a corporate entity, it requires that the minority own 50 percent or greater interest in the corporation. But in a partnership structure, which is the nature of the Viacom transaction, the only requirement is that the minority general partner own a 20-percent or greater profits interest in the partnership.

Because partnerships have a fair degree of flexibility in terms of structure, in this particular transaction it is possible to give Mr. Washington a 20-, 21-percent profits interest. But, as I said to the chairwoman, that does not mean he is receiving a 20-percent interest in $2.3 billion; rather, the $2.3 billion is probably structured as representing an interest that stands ahead of the profits interest.

Now, let me just say that we have not reviewed the transaction documents in this transaction. So we are making some judgment

about how we believe the deal is structured based on what we have seen in the published news reports and the press release which Viacom issued.

Mr. RAMSTAD. But is the contention that a $1 million investment in a $2.3 billion transaction meets this threshold?

Mr. KIES. Apparently the FCC standard is that as long as the general partner owns a 20-percent or greater profits interest or equity interest in the partnership, then that satisfies their requirement. I believe they will tell you that the reason they take that position is because, under those circumstances, the general partner, they believe, is in control of the entity and can control broadcast or programming decisions and things of that nature, and that is the basis for their policy.

Mr. RAMSTAD. I thank you for that clarification.

Thank you, Madam Chair.

Chairman JOHNSON. Thank you.

Mr. Zimmer will inquire.

Mr. ZIMMER. Thank you, Madam Chairman.

I would like to follow up on that line of inquiry. Mr. Ramstad has been inquiring as to the degree of ownership involved. But ownership, especially ownership where the profit is subordinated to senior debt and preferred stock, does not necessarily translate into control.

Does the FCC have a working definition of what actual control is above and beyond a mere ownership interest?

Mr. KIES. Well, their definition, and you may want to ask them about this with more specifics, but as we understand it, their definition is that control exists for purposes of section 1071 in those circumstances when a minority general partner has a 20-percent or greater interest in the partnership, because the minority is the general partner and general partner status confers the ability to control the decisionmaking of the business entity itself.

Mr. ZIMMER. That is a pretty legalistic definition. From my experience in the corporate world, control follows the golden rule, he who has the gold, rules. The FCC does not take into account the fact that here you have a multibillion dollar transaction where only $1 million of equity is being put up by a so-called control person. That is not taken into account, as far as you know?

Mr. KIES. As we understand it, they follow basically a mechanical rule rather than what I think you would refer to as more of a subjective rule. But that is the basis on which they administer this particular program.

Mr. ZIMMER. Here is a question you may not be able to answer, but could you give me your best estimate of how much of the financial benefit that is created by this tax certificate is going to Mr. Washington and how much of it is going to Viacom?

Mr. KIES. Well, our analysis, because it appears that Viacom is receiving a purchase price that is at or above fair market value, would lead to the conclusion that none of the tax benefit is going to Mr. Washington and all of it is going to Viacom.

There is testimony you are going to receive later this morning from one of the witnesses that has done some of these programs, and in his testimony he says that in these transactions none of the tax benefit goes to the minority purchaser and it all goes to the

seller. I don't know if that is reflective of all the transactions, but at least that is the testimony of one of the witnesses you are going to hear.

In looking at this particular deal, it appears to us that the tax benefit is going to Viacom and not to the minority purchaser.

Mr. ZIMMER. I would point out that testimony to Mr. McDermott as a reason why maybe we should be investigating this tax provision.

It seems to me this is, in theory, trickle-down economics but it is not even that in practice because nothing is trickling down. I would like to commend the chairwoman for starting off our hearings in the very first month of the new Congress by looking at what has been called by the administration, corporate welfare.

I know that the Secretary of Labor and I know that the Democratic Leadership Council have expressed a great interest in this subject. I hope this is not the last issue that we investigate along these lines. I hope some of the loopholes that we investigate will be those that spark the interest of Mr. McDermott and the concern of Mr. McDermott, as well.

Thank you very much.

Chairman JOHNSON. Thank you. Mr. McDermott.

Mr. MCDERMOTT. Thank you, Madam Chairman.

I find myself here trying to defend an entrepreneur. That is a little strange for me politically, but it seems like we ought to ask some questions.

One of the fascinating things, Mr. Kies—I know that you work for us, and so I know that what you have done is at the direction of somebody. It is amazing you can come up with this great big annotated study of all of the things—even with footnotes. I mean there are hundreds of footnotes in here about all these things, and have meetings with FCC and everything else, but you have no tax and revenue estimates on the Contract With America.

It seems like sort of an imbalance in your workload. I really feel sorry for you that they have spent your 2 weeks wasting your time on this issue when you should have been working on the Contract.

But I would like to ask a question, and that is this: In Chairman Archer's press release he said any changes—and this is a quote—"any changes in section 1071 may apply to transactions completed or certificates issued by the FCC on or after today, January 17, 1995."

Now, to what extent is that effective date retroactive?

Mr. KIES. Well, I would say retroactivity sometimes is in the eye of the beholder.

Mr. MCDERMOTT. I understand that, that is why I am asking the question. I want to know what I should see.

Mr. KIES. I would not purport to tell you what you should see, but I think that the effort or my guess is the intent of Mr. Archer was to try to put people on notice that if there is going to be action, it will apply to these transactions.

So I think it was an effort to avoid the situation that is deemed repugnant about retroactivity, and that is if people go forward in reliance on current law without being aware that there is a potential change of law that could change their result. In the case of the Viacom transaction, and, again, we have not reviewed the docu-

ments, but according to the press release, they themselves apparently recognize that the Archer press release has some significance because they have conditioned actually being able to close the deal on the ability to get the FCC certificate.

So I gather Mr. Archer was trying to fairly put people on notice that any action in this area could affect a transaction after that date.

Mr. MCDERMOTT. So would it be your judgment, then, that this is not retroactive at all? It just starts on January 17, anything from this point on? Nobody else has a deal out there that should be worried?

Mr. KIES. Well, it would be, I think, our judgment from a tax policy perspective that for transactions that had not even been signed prior to January 17 clearly, to the extent they are impacted, this would not represent retroactivity because they are on notice.

Mr. MCDERMOTT. I understand future and past, what I want to understand is when does the past begin. If they did a deal in December, would that—this would not hit them?

Mr. KIES. Well, no, it could, because if the deal was signed in December, according to—if the terminology of the press release were applied, there could be a transaction that was signed in December but the application for the FCC certificate might be pending, and not have been granted yet. So under the pure reading of that language, that transaction could be affected.

I think one of the decisions the subcommittee will have to make if they decide to enact this area is whether or not that situation would merit some kind of transition rule.

Mr. MCDERMOTT. Are you aware of any other tax certificates which are pending?

Mr. KIES. We have not—let me put it this way. We have been kind of busy on this and the Contract With America, so——

Mr. MCDERMOTT. I am glad to hear that.

Mr. KIES. So I have been getting a lot of phone calls I have not been able to return. Some of them may be from people who have transactions that are pending, and I have a feeling we will learn about those pretty quickly.

But we have not been able to compile a list. The FCC might be able to tell us how many FCC applications are pending for current deals. That is not information we have right now.

Mr. MCDERMOTT. I want to understand this issue. What is it about the Viacom deal that makes this one so important or so flagrant? Has there never been a deal like this before? Are we looking at the first time that somebody got in for a little bit of money?

Mr. KIES. Well, again, we have a limited amount of information about other transactions just because we are in the gathering stage. But it has been reported—I think, as a matter of fact, Mr. Matsui alluded to another transaction Mr. Washington was in with Jack Kent Cook that I believe the press reports was a $600 million deal.

This is an issue that the subcommittee, the Select Revenue Measures Subcommittee actually took testimony on, I believe in 1993. It is an issue that has been written about in Fortune Magazine and other places, a number of times in the past couple of years. So it is not—it is not the first time anybody has raised the

question of section 1071. This transaction, I believe, is larger than any other that has ever come through the FCC, although again, they would be better to ask about that.

But I think what has attracted a lot of attention to this transaction is its size and the fact that the minority investor does appear to have a relatively modest investment relative to the size of the transaction.

Mr. MCDERMOTT. I hope that in the testimony that we hear from other people, we will hear the answers to those questions, since I would grant you, you have had a few things to do since the first of the year and may not have all the data that is necessary on this.

It always seems to me that fairness is the issue. If you are going to do it to one person, you should do it to everybody. If you are going to do it here, in this place, you should do it in that place. You should not be picking and choosing.

I would like to know whether this is here because it is the worst deal that has ever been concocted with a Federal bureaucrat and some entrepreneur or is it just one of a whole series of things? As I pointed out before, there are all kinds of tax giveaways in this Tax Code of ours. This is not the only place where we have some egregious deals. We have oil and gas things that are totally unrelated to cost. The oil depletion allowance is a figment.

So I really—I want to know why this one is the one that triggers this great interest in roaring through here with something.

Thank you, Madam Chairwoman.

Chairman JOHNSON. Mr. Johnson will inquire.

Mr. JOHNSON of Texas. Thank you, Madam Chairman. I think in answer to your question, you might say that we have been trying to change some of these rules for some period of time and have not had the opportunity to do it and are doing it now.

I have two cases here in front of me which you may be aware of. One happened in Dallas, Tex., and the other in Washington with Jack Kent Cook which were deals where a minority put up some $30,000 for a deal over $600 million and got a certificate, because they, "gave him 51 percent." My question is, I guess, how many of these involve big companies? These two deals, the one in Dallas and here were Times Mirror. That is a pretty large company to be getting tax exemptions. It is not the minority that is benefiting, it is the big company that is benefiting.

If, in turn, the minority has 200,000 shares of stock that he can sell to a majority stockholder who is not a minority, does that tax exemption reduce the cost of the stock that he is selling, and then is it tax free? Is that money tax free from that point forward?

Mr. KIES. Mr. Johnson, are you asking whether the minority investor, if he sells his stock subsequently, whether that is tax free?

Mr. JOHNSON of Texas. Yes.

Mr. KIES. That transaction——

Mr. JOHNSON of Texas. You made a statement earlier that if the stock were, in fact, sold, the price would be reduced or could be reduced by the amount of the tax exemption.

Does that mean that if that happens, that the stock is sold at a lesser price, let's say; that that tax exemption then is wiped off the books?

Mr. KIES. If on January 1 a seller, like a Viacom, were to sell to this new entity and then have this deferred gain of let's say $1 billion, and it went and bought stock and got a lower basis and then were to sell that stock at its fair market value, that gain would be taxed, unless that was another transaction in which a 1071 certificate might be granted.

Mr. JOHNSON of Texas. But the original tax exemption is never recovered if that is applied to the stock sale and the price is reduced; is that true?

Mr. KIES. If the reinvestment of proceeds is in stock, the acquirer, like Viacom, will get a lower basis because of the rules that apply to the purchase of replacement property.

Mr. JOHNSON of Texas. Rightly.

Mr. KIES. So that when and if Viacom were to sell that stock interest, it would pay the tax, unless it was in another 1071 transaction. But it is likely——

Mr. JOHNSON of Texas. Or if there were no capital gains involved.

Mr. KIES. If the purchase price were so low that it was less than the basis. In most cases, people probably are not going to go out and sell the replacement property any time soon because they would have to pay the tax. But if they did, they would pay the tax at that point in time.

Mr. JOHNSON of Texas. OK. Are you aware of these two cases I mentioned?

Mr. KIES. I think the one you alluded to is the Jack Kent Cook.

Mr. JOHNSON of Texas. One of them is.

Mr. KIES. That I am aware of. I am not aware of the other.

Mr. JOHNSON of Texas. Well, there were two I think in Washington. But, nonetheless, it seems to me that we are talking about 40 and 60 million dollars' worth of taxes that were forgiven in those deals, and I know it is not as big as the one we are talking about now, but do you think that we should recover those dollars for the Federal Government as long as that tax is on the books and/or what is your opinion of the FCC having the sole authority to regulate that tax?

Mr. KIES. Well, as we said in our testimony, the discretion that is given to the FCC by the Internal Revenue Code appears to be fairly unique. I think from the standpoint of tax writing committees, that historically the tax writing committees have not been willing to give away the kind of discretion that is in this provision.

Mr. JOHNSON of Texas. Is that the only agency in the government that has that power?

Mr. KIES. It is the only one we are aware of other than the case where the State Department has the ability to designate combat zones, which only provides a benefit that allows military personnel that are stationed there to file their tax returns late. So that is relatively insignificant. But we are not aware of any other place where the code grants that kind of discretionary authority.

Mr. JOHNSON of Texas. Thank you. Thank you, Madam Chair.

Chairman JOHNSON. Thank you, Mr. Johnson, and thank you, Mr. Kies. Unless there are further questions.

Mr. HERGER. Madam Chair.

Chairman JOHNSON. Mr. Herger.

Mr. HERGER. Mr. Kies, just one further question. Putting this all in perspective, we are saying the only two examples that you know of in the Federal Government, one is where we have servicemen and women who are perhaps risking their lives in a combat zone, they can file their taxes a little bit later; and this situation where we see individuals, or at least the taxpayers losing out in this one case maybe as much as $600 million collectively, between State and Federal Government.

Also, it would appear that the major winners here are not really the minority, although it would sound like Mr. Washington is doing quite well, but it would really be the stockholders, who I am sure the vast majority are not minorities in these companies who are benefiting from all these hundreds of millions of dollars directly or indirectly; is that correct?

Mr. KIES. To the extent that the tax benefit is staying with the seller rather than the minority-controlled buyer, that is certainly correct.

I just might add one thing, and that is that this particular provision, when it was enacted in 1943 and all the way up to 1978, was really targeted at one very narrow problem and that was the situation where an owner had two broadcast properties in the same market that were competing against one another, and it was the FCC policy not to have that situation.

So from 1943 to 1978, it was administered in a fairly narrow fashion, although it was expanded to cable television and television properties. But at least up to that point, the discretion was not exercised to the extent it has been since 1978.

Mr. HERGER. One last quick question. It sounds like, at least under what we are allowing FCC to do right now, quite a good deal if you can get involved. I am curious, what is the FCC's criteria that they have established for a minority identity? How do we determine who qualifies for this?

Mr. KIES. Under the policy as adopted, a minority is defined as—I think I had it in my testimony—African-Americans, Asian-Americans, I believe Alaskan Indians, Asians—I may have left out one—and Hispanic Americans, thank you—they have also, in another expansion of the program, extended it to women, to some extent, as it relates to these personal communications systems. So there has been a little bit of an expansion there. I believe, not the tax certificate program but some other benefits are extended to rural telephone systems and small business.

But I do not think that is the tax certificate program. I think that is the rulings under which they are selling off these personal communications systems. They would be much better informed about that than I am.

Mr. HERGER. I just caught part of this, and maybe it is not pertinent, but in our bipartisan briefing yesterday afternoon you were mentioning something about an individual of Italian descent. Does that have anything to do with this?

Mr. KIES. There is a transaction that is reported in Forbes Magazine that indicates that the sale of a broadcast property from Storer Communications to—according to the article—the Liberman family qualified for a certificate because the Liberman family was

able to demonstrate that their descendants had been driven out of Spain in 1492 by Ferdinand and Isabella.

Now, I believe the FCC, because we did ask the FCC about this particular transaction, will tell us that that particular family is very visible in the Hispanic community. So unlike what the Forbes Magazine article implies, the only basis under which they got it was an event in 1492. I think the FCC, because we did ask them about it, has told us that part of their decision as to whether or not those purchasers qualified as a minority was affected by the role that they do play in the Hispanic community. Again, you may want to ask them about that because they are much more familiar with the specific facts of that transaction than we are.

Mr. HERGER. This seems to become more and more bizarre the more we get into it.

Thank you very much. I have no further questions.

Chairman JOHNSON. Thank you very much for your testimony, Mr. Kies. We would like now to hear from William Kennard, general counsel for the FCC, and Glen Kohl, the tax legislative counsel for the Department of Treasury.

We welcome you. We are interested in what you have to say about the really unique and remarkable latitude that the FCC has under these provisions and particularly with regard to the billions of dollars of public tax money at stake.

Mr. Kennard, why don't you proceed.

STATEMENT OF WILLIAM E. KENNARD, GENERAL COUNSEL, FEDERAL COMMUNICATIONS COMMISSION

Mr. KENNARD. Thank you very much, Madam Chair.

Thank you, and thank you members of the subcommittee for the opportunity to explain today the history and administration of the FCC's tax certificate policies.

Section 1071 of the IRS Code authorizes the FCC to permit sellers of broadcast properties to defer capital gains taxes on a sale or exchange if the sale or exchange is deemed by the FCC to be "necessary or appropriate to effectuate a change in policy of, or the adoption of a new policy by, the Commission."

We have heard a lot about the history of section 1071 from Mr. Kies, so I will not review the legislative history in detail. But I would like to clarify one statement made by Mr. Kies with respect to the use of tax certificates in the personal communications service, which is a fairly exciting new service that the FCC has authorized, and, in fact, as we speak today, we are auctioning off spectrum for that service.

The FCC was mandated by Congress to consider extending tax certificates to PCS to advance ownership by women and minorities. So I did want to clarify that was at the request of Congress and not something the FCC did on its own.

I would also like to provide a little history of the tax certificate policy as it has been used to promote minority ownership in broadcasting and cable. Promoting minority ownership has been a longstanding goal of both the FCC and the Congress. The Commission, the courts, and the industry began focusing in the late 1970s on the severe underrepresentation of minorities in the broadcasting industry. There was a feeling that this dearth of representation did

not promote diversity over the public airwaves. So in 1978, the FCC, at the request of the National Association of Broadcasters, adopted a policy statement which, for the first time, extended the use of tax certificates to promote minority ownership in broadcasting.

Congress has made very clear to us its view that this is an important policy goal, and, in fact, since 1988 Congress has expressly prohibited the Commission from spending any appropriated funds to modify or repeal any of its minority ownership policies, including the tax certificate policy.

Essentially, this is how the program works from the FCC perspective. The FCC controls the transfer of licenses. In connection with the transfer or assignment of an FCC license, if there is a tax certificate request, the seller and the purchaser come to the FCC, submit a pleading, typically in connection with the application to assign the license, and they request a tax certificate.

The Commission staff requires that there be certifications of minority ownership and control. Typically, the staff of the FCC is presented with the various financing documents, which govern these deals, and the Commission then determines whether in the context of a particular deal there is sufficient minority ownership and control to justify the issuance of a tax certificate.

Under the statutory scheme of section 1071, the Commission is required to certify whether a transaction would promote the minority ownership policy. That certification is done in the form of a tax certificate which is given to the seller. The seller then is required to file that tax certificate with its tax return to get the deferral benefits that you have heard about.

The tax certificate became an important cornerstone of the Commission's policies to advance minority ownership in broadcasting. In 1982 the Commission, under the leadership of Chairman Mark Fowler, convened kind of an industry-government summit to examine ways to improve minority ownership, not only in broadcasting but in other technologies. It was at that time in 1982 that the Commission extended the policy to encompass cable television.

In terms of the numbers of tax certificates granted, since we provided information to the subcommittee staff yesterday, we have been in a continuing process of trying to respond to data requests. We did find that the Commission has issued a few more tax certificates than we had told the subcommittee yesterday, so I just wanted to get that on the record, and note that since 1978 the Commission has granted approximately 390 tax certificates. Approximately 330 of those involve sales to minority-owned entities. The vast majority are for radio properties, 260. There are 40 for television stations, and approximately 30 have been granted for cable television station transactions.

Questions were asked earlier about whether these certificates that have been granted reflect grants to a diverse number of buyers. We have not massaged all that data yet and we welcome the opportunity to do that, but our preliminary comparison of the number of tax certificates granted with the actual lists of the numbers of minority owners suggest that it is a fairly diverse group. There are some individuals and companies who have taken advantage of the program multiple times, but that does not seem to be the rule.

We also have done some analysis of the average period of time that minority buyers hold stations and cable systems subject to a tax certificate. In broadcasting we have determined that even though there is a 1-year holding period, most minority buyers retain the licenses for much longer. The average is about 5 years. About a third of the tax certificates that have been granted for minority ownership, that is for about 100 deals, the stations are still being held by the minority purchasers.

The great majority of these transactions are quite small. We have heard a lot today about the Viacom transaction. That would certainly be, by far, the biggest minority tax certificate request ever made to the agency. The average sales price, that is sales price, not tax deferral, but the average sales price for a radio transaction is $3.5 million. For the 40 tax certificates we have granted with respect to television stations, the number is higher, it is about $38 million, average sales price.

Data is not available for the 30 cable transactions that we have processed.

To summarize, the minority tax certificate policy was designed as a way to provide incentives for established holders of broadcast and cable properties to sell those properties to minorities. It has emerged as probably the principle policy incentive for the sale of existing properties to minorities as opposed to licenses granted through the initial licensing process.

I am certainly not here to tell you that the program is perfect. There is considerable room for improvement in the program. I do note that the Commission has been severely constrained in its ability to make changes and reevaluate the program because of the appropriations rider that we are subject to. That rider, just to summarize, requires that the Commission not reexamine, change, modify, or repeal the policy, so we have been forced to continue to grant tax certificates under the policy in effect since 1986, subject only to expansions or improvements of the policy.

If given the authority by Congress to reevaluate this program, I am confident that there are many ways it could be improved, both in its administration and cost effectiveness. I would like to thank you once again for the opportunity to testify this morning, and I would be happy to answer any of your questions.

[The prepared statement and attachment follow:]

STATEMENT OF WILLIAM E. KENNARD, GENERAL COUNSEL
FEDERAL COMMUNICATIONS COMMISSION

Chairwoman Johnson and Members of the Subcommittee:

Thank you for the opportunity to explain how the Federal Communications Commission has used Section 1071 of the Internal Revenue Code to further the FCC's and Congress' policies.

I. Introduction and Overview

Section 1071 of the Internal Revenue Code authorizes the FCC to permit sellers of broadcast properties to defer capital gains taxes on a sale or exchange if the sale or exchange is deemed by the agency to be "necessary or appropriate to effectuate a change in a policy of, or the adoption of a new policy by, the Commission with respect to the ownership and control of radio broadcasting stations." 26 U.S.C. § 1071.

Section 1071 was enacted in 1943 to alleviate the hardship of involuntary divestiture associated with the Commission's newly adopted multiple ownership rules. Those rules limited radio licensees to ownership of one outlet per market, and, as a result, approximately 35 licensees were required to sell overlapping stations. Later, tax certificates were used in voluntary transfers as an incentive to licensees to divest themselves of properties grandfathered under another provision of the multiple ownership rules which limited the number of stations a single entity could own nationwide.

Since that time, the FCC has used tax certificates in other contexts to further the goals of national communications policy. Today, the FCC issues tax certificates to encourage:

- licensees to come into compliance with the FCC's multiple ownership rules
- microwave licensees to relocate to other frequencies to facilitate licensing of personal communications services
- owners of AM radio to divest themselves of licenses in certain frequency bands to reduce interference
- minority ownership.

I understand that this Subcommittee is most interested in the FCC's use of tax certificates to promote minority ownership of broadcasting stations and cable television systems so I will focus on that area in my testimony today.

II. The FCC's Minority Tax Certificate Policy

A. Development of the Policy

Recognizing that the viewing and listening public suffers when minorities are underrepresented among owners of broadcast stations, the Commission began working to encourage minority participation in this industry in the late 1960s. Its first step was to formulate rules to prohibit discrimination in hiring and, several years later, in response to a court decision, it began to consider minority status in comparative licensing proceedings.

The FCC's minority ownership policies have been supported and expanded by Congress over the years. For example, in 1982, Congress added Section 309(i)(3)(A) to the Communications Act, which directs the Commission to accord preferences to minority applicants participating in lotteries to award certain broadcast licenses.

The decision to grant tax certificates in sales involving minority buyers was prompted by requests from the broadcasting industry and others in the 1970s. In 1978, the Commission's Minority Ownership Task Force reported that although minorities constituted approximately 20 percent of the population, they controlled fewer than one percent of the 8500 commercial radio and television stations then operating in the United States. Thus, the

National Association of Broadcasters (NAB) proposed that the FCC establish a minority tax certificate policy to provide incentives for established broadcasters to sell radio and television stations to minority entrepreneurs.

The Commission agreed with NAB that underrepresentation by minorities contributed to a dearth of representation of minority views over the public airwaves. The Commission determined that an increase in ownership by minorities would inevitably enhance the diversity of programming available to the American public. Therefore, in 1978, the Commission issued a policy statement in which it determined that it would grant tax certificates to licensees that assign or transfer control of their authorizations to minority-controlled entities. Statement of Policy on Minority Ownership of Broadcasting Facilities, 68 FCC 2d 979 (1978).

In 1981, the Chairman of the FCC, Mark Fowler, began a review of the Commission's minority ownership policies with the goal of finding creative ways to advance minority ownership. To assist in this effort, he established the Advisory Committee on Alternative Financing for Minority Opportunities in Telecommunications. The Advisory Committee identified lack of access to capital as the largest obstacle to minority ownership and identified the tax certificate as a successful way to enable minorities to attract financing.

As a result, the Commission, by a unanimous vote, took a number of steps in 1982 to make the tax certificate policy more effective in providing meaningful opportunities for minorities to enter the communications business.

First, it extended the tax certificate policy to sales of cable television systems. The Commission determined that cable operators, like broadcasters, exercise discretion in determining which broadcast and non-broadcast signals they will carry and, thus, taking steps to increase minority ownership would help to ensure that the viewpoints of minorities are adequately represented in cable television system programming.

In expanding the tax certificate program to cable systems, Chairman Fowler emphasized in a separate statement endorsing the Commission's decision that such actions aim squarely at the problem of minority financing opportunities. Mr. Fowler noted: "As President Reagan has said, the best hope for a strong economic future rests with a healthy, growing private sector. And the private sector does best when all have opportunities to enter it." See Statement of Policy on Minority Ownership of CATV Systems, 52 R.R.2d 1459 (1982).

Second, the Commission modified the policy to allow issuance of tax certificates to investors in a minority-controlled broadcast or cable entity upon the sale of their interests, provided that the interests were acquired to assist in the financing of the acquisition of the facility. Commission Policy Regarding the Advancement of Minority Ownership in Broadcasting, 92 FCC 2d 849 (1982). The Commission found that by broadening the tax certificate policy in this manner "the pressing dilemma minority entrepreneurs face -- the lack of available financing to capitalize their telecommunications ventures -- is met and a creative tool of financing is created."

In 1990, the FCC's minority ownership programs were upheld as constitutional by the United States Supreme Court. The Court held that the Commission's policies designed to increase minority ownership were substantially related to the achievement of a legitimate government interest in broadcast diversity and that they did not impose an impermissible burden on nonminorities. Metro Broadcasting, Inc. v. FCC, 497 U.S. 547 (1990). Although the Court decision did not specifically involve tax certificates, the rationale for the decision clearly applies to this program.

B. Legislative Constraints on Changes to the Minority Tax Certificate Policy

Late in 1986, the Commission became concerned about the continuing validity of its

minority ownership programs and commenced a proceeding aimed at determining whether these programs were appropriate as a matter of policy and constitutional law. It asked for public comment on a number of issues, including whether the Commission should continue to grant preferences to minorities and what social or other costs might result from the policies. Reexamination of the Commission's Comparative Licensing, Distress Sales and Tax Certificate Policies Premised on Racial, Ethnic or Gender Classifications, MM Docket No. 86-484, FCC 86-549, released December 30, 1986.

Congress reacted to the Commission's attempt to reevaluate its minority ownership policies by attaching a rider to the FCC's 1988 appropriations bill explicitly denying the Commission authority to spend any appropriated funds "to repeal, to retroactively apply changes in, or to continue a reexamination of, the policies of the Federal Communications Commission with respect to comparative licensing, distress sales and tax certificates granted under 26 U.S.C. 1071, to expand minority ownership of broadcasting licenses . . . ." Congress also ordered the Commission to terminate the proceeding reexamining its minority ownership programs and to reinstate the prior policy. Pub. L. No. 100-202, 101 Stat. 1329 (1987). This rider has been reenacted by Congress each year since 1988.

In the 1994 appropriations legislation, Congress clarified in the House Conference Report that the prohibition on reexamination is "intended to prevent the Commission from backtracking on its policies that provide incentives for minority participation in broadcasting" but that it "does not prohibit the agency from taking steps to create greater opportunities for minority ownership." H. Conf. Rep. No. 103-708, 103d Cong. 2d Sess. 40 (1994) (emphasis added). Therefore, the Commission has been greatly constrained in its ability to review the administration and effectiveness of the tax certificate program.

C. Administration of the Tax Certificate Program

Because the rider to the FCC's appropriations bill prevents the Commission from spending appropriated funds to impose limitations on the minority tax certificate program, the Commission must consider tax certificate requests in accordance with the policy as it was in effect in 1986, subject only to changes that would expand the policy.

A tax certificate allows a seller to defer capital gains taxes incurred in the sale of a communications property. Under Section 1071 of the Internal Revenue Code, this deferral can be accomplished by treating the sale as an involuntary conversion under 26 U.S.C. § 1033, with the recognition of gain postponed by the acquisition of qualified replacement property, or by electing to reduce the basis of certain depreciable property, or both.

Thus, the certificate provides incentives to licensees to sell to minority entrepreneurs, while at the same time enhancing the buyer's bargaining position. Section 1071 also encourages reinvestment in communications infrastructure by requiring the seller to reinvest the gains from a tax certificate transaction in similar property.

A request for a tax certificate is submitted to the Commission in letter or petition form. In the broadcast context, the request is usually filed in conjunction with a sale and, thus, the parties also are required to submit applications for consent to assign or transfer control of the relevant license. Ownership information about both the seller and buyer is contained in these applications, and any interested party may oppose the grant of the tax certificate or of the sale.

To receive a minority tax certificate, the minority principals must demonstrate that they exercise both de facto and de jure control of the buyer. If the purchaser is a limited partnership, the minority general partner must own more than a 20 percent equity stake in the company. The minority status of individuals is determined by reference to the Office of Management and Budget's ethnic group or country of origin classifications.

The Commission reviews applications and tax certificate requests carefully and often asks the parties for additional information. The Commission has denied grant of tax

certificates when the parties failed to demonstrate minority control or to satisfy other criteria.

If the Commission determines that grant of a tax certificate is warranted under its tax certificate policies and prior tax certificate decisions, it will issue the certificate to the seller, which in turn submits it to the Internal Revenue Service with its tax return.

D. Results of the Tax Certificate Policy

Before 1978, minorities owned approximately .05 percent (40) of the approximately 8,500 total broadcast licenses issued by the FCC. A 1994 study performed by the National Telecommunications and Information Administration of the Department of Commerce indicates that as of September 1994, there were approximately 323 commercial radio and television stations owned by minorities, 2.9 percent of the total 11,128 licenses.

Industry Total	Black	Hispanic	Asian	Native American	Minority Totals
AM Stations 4,929	101 (2%)	76 (1.5%)	1 (0%)	2 (0%)	180 (3.7%)
FM Stations 5,044	71 (1.4%)	35 (.7%)	3 (.1%)	3 (.1%)	112 (2.2%)
TV Stations 1,155	21 (1.8%)	9 (.8%)	1 (.1%)	0 (0%)	31 (2.7%)
Cumulative Totals 11,128	193(1.7%)	120(1.1%)	5(0%)	5(0%)	323 (2.9%)

Between 1943 and 1994, the Commission has granted approximately 507 tax certificates; 390 were granted between 1978 and 1994. Approximately 330 of the total involved sales to minority-owned entities; 260 for radio station sales, 40 for television and low power television sales, and 30 for cable television transactions.

Although FCC regulations require the buyer of a property for which a tax certificate is issued to hold that station for one year, the overwhelming majority of minority buyers retain their licenses for much longer. Of the 290 broadcast transactions in which tax certificates were granted between 1978 and 1993, the average holding period was approximately five years. We have not included 1994 tax certificate transactions in this figure because those licenses have been held for less than one year. In more than 100 cases in which minority tax certificates were granted, the station still is held by the original purchaser.

The great majority of the transactions in which tax certificates are awarded are relatively small, averaging a sale price of $3.5 million for radio. The 40 tax certificates we have granted for television station sales have a higher average sale price of $38 million. Data is not available for the 30 cable sales, although we know that cable transactions tend to be larger.

III. Conclusion

The minority tax certificate policy is the cornerstone of the Commission's policies to remedy the underrepresentation of minorities in the ownership of broadcast and cable facilities. Most of the broadcast and cable television sales to minorities that took place after 1978 would not have occurred without the existence of the tax certificate policy. And there has been a marked increase in minority ownership since 1978. Further, the program does not seem to have suffered from rampant abuse, such as a lack of real minority control of licenses or quick "flipping" of facilities.

At the same time, as we have stated, the Commission has been constrained in its

ability to subject the program to a comprehensive reexamination. As with any program, this one could benefit from periodic review and improvement. If given the authority by Congress to undertake a reevaluation of the tax certificate policy, I am confident that the Commission could improve the administration and cost effectiveness of the minority tax certificate program.

This concludes my formal remarks. Once again, thank you for inviting the FCC to testify this morning. I would be happy to answer any of your questions.

Chairman JOHNSON. Thank you, Mr. Kennard. Your testimony was very, very interesting, particularly interesting that we would put something like that in the law as far back as 1988 and never do any oversight of the impact of that prohibition.

Mr. Kohl.

STATEMENT OF GLEN A. KOHL, TAX LEGISLATIVE COUNSEL, U.S. DEPARTMENT OF THE TREASURY

Mr. KOHL. Madam Chairwoman and members of the subcommittee, I am pleased to have this opportunity to present testimony on behalf of the Department of Treasury concerning section 1071 of the Internal Revenue Code. However, because the issues identified by the subcommittee relate primarily to the responsibilities assigned by Congress to the FCC, questions about section 1071 certificate program itself are more properly directed to Mr. Kennard. My testimony is intended simply to provide an overview of section 1071, including recent testimony on section 1071 and an explanation of the Internal Revenue Service's role in its administration.

In September 1993, the Ways and Means Subcommittee on Select Revenue Measures conducted a hearing on miscellaneous revenue measures, including an unspecified proposal "that would modify section 1017 by adding anti-abuse rules to ensure that tax incentives are available only for sales that actually foster minority ownership of broadcast stations." The assistant secretary for Tax Policy, Les Samuels, testified that we would not oppose a carefully targeted amendment to section 1071 that would prevent certain sellers, e.g., those who actually participate in sham transactions, from taking advantage of section 1071, provided the amendment did not deny such preferential treatment to innocent sellers, that is, taxpayers who participate in a sale that results in bona fide minority ownership.

Our position in this regard has not changed. Accordingly, we would be willing to work with the subcommittee or the FCC in attempting to craft anti-abuse provisions we could support. In addition, we would be pleased to consider in conjunction with the subcommittee and the FCC whether a cap or other limitations on the section 1071 benefits would be necessary and appropriate to target more precisely this tax provision to its desired objective.

Under section 1071, Congress has delegated authority to the FCC to issue section 1071 certificates. Under the statute, tax benefits under section 1071 are available if the taxpayer obtains a section 1071 certificate from the FCC. The IRS is not in a position to either participate in or exercise oversight over the FCC's determination that many a transaction waits a change in FCC policy. Consequently, as noted by Mr. Kies, the IRS's role is limited to administering, interpreting the technical requirements of section 1071 and section 1033, a provision which section 1071 incorporates by reference.

I would now like to address the potential for abusing section 1071. Please keep in mind, however, that because of, among other things, the lack of the IRS's participation in the certification process, my testimony should not be construed as commenting on any particular transaction, including recent transactions that have been covered in the press.

I should also point out that abusive transactions may arise in any statutory or regulatory context. As you are certainly aware, Treasury, the IRS, and the courts expend considerable energy and resources dealing with abusive tax transactions. Fortunately, the tax law, like other statutory regimes, is interpreted in a manner consistent with its spirit and purpose. Reflecting this rule of interpretation, tax doctrines have evolved in the common law to combat such abuse.

These doctrines include a prohibition against sham transactions, a rule that a transaction must be taxed in accordance with its substance and not merely how it is papered or its form, the substance-over-form doctrine; and a rule that certain related transactions are to be aggregated and treated as one overall transaction, the step transaction doctrine.

In addition, various provisions in IRS regulations have been adopted to address abuses because the common law doctrines have not been fully successful in combating abusive transactions. Certification under section 1071, however, is conducted by the FCC, not the IRS. I assume that, like any regulatory agency, the FCC deals with attempts to abuse its rules including the rules governing the issuance of section 1071 certificates.

In the absence of adequate safeguards against abuse, it is possible that an aggressive participant could devise a scheme that might enable parties to obtain a section 1071 certificate even in situations that do not meaningfully enhance the ownership of broadcasting properties by minorities or women. If such a scheme were to succeed, granting the section 1071 certificate would unfairly reward the participants of a tax avoidance scheme at the expense of both a bona fide minority ownership group and a nonminority ownership group that was unwilling to engage in an abusive transaction.

Once again, however, I am not in a position to comment on whether there in fact exists any transactions when the grant of a section 1071 certificate is not consistent with the intent or purpose of section 1071 or any regulations promulgated there under. Such a question is more properly directed to the FCC.

Nevertheless, as I previously stated, we would be pleased to consult with the FCC or this subcommittee in developing further safeguards against the abuse of the certification process, through anti-abuse provisions and/or specific measures, such as a more stringent holding period. We would also be pleased to work together toward other means of tailoring the section 1071 benefits, for example, some sort of cap, to more efficiently promote its objectives.

This concludes my remarks.

Thank you once again for affording me the opportunity to testify, and I am now available to answer any questions that the subcommittee may have.

[The prepared statement follows:]

STATEMENT OF
GLEN A. KOHL
TAX LEGISLATIVE COUNSEL
DEPARTMENT OF THE TREASURY
BEFORE THE
WAYS AND MEANS SUBCOMMITTEE ON OVERSIGHT
U.S. HOUSE OF REPRESENTATIVES

Chairwoman Johnson and Members of the Subcommittee:

I am pleased to have this opportunity to present testimony today on behalf of the Department of the Treasury concerning section 1071 of the Internal Revenue Code. In convening this hearing, the Subcommittee indicated its desire to examine four issues: (i) whether the Federal Communication Commission's (FCC) 1978 policy of promoting minority ownership is consistent with the underlying intent of Section 1071; (ii) whether the FCC's administration of section 1071 constitutes an impermissible exercise of legislative authority; (iii) whether the tax incentive provided in section 1071 fosters minority ownership of broadcast facilities; and (iv) whether the FCC policy is a necessary or appropriate means of achieving this goal.

Because the issues identified by the Subcommittee relate primarily to the responsibilities assigned by Congress to the FCC, my testimony is intended simply to provide an overview of Section 1071 -- including recent Treasury testimony on Section 1071 -- and an explanation of the Internal Revenue Service's (IRS) role in its administration.

In September, 1993, the Ways and Means Subcommittee on Select Revenue Measures conducted a hearing on miscellaneous revenue measures, including an unspecified proposal "that would modify section 1071 by adding anti-abuse rules to ensure that tax incentives are available only for sales that actually foster minority ownership of broadcast stations." The Assistant Secretary (Tax Policy), Leslie B. Samuels, testified that we would not oppose a carefully targeted amendment to section 1071 that would prevent certain sellers (e.g., those who actively participate in sham transactions) from taking advantage of Section 1071, provided the amendment did not deny such preferential tax treatment to "innocent" sellers -- that is, taxpayers who participate in a sale that results in bona fide minority ownership. Our position in this regard has not changed. Accordingly, we would be willing to work with the Committee or the FCC in attempting to craft anti-abuse provisions that we could support and which would not reduce the effectiveness of the program. In addition, although the Administration has no position on this matter, we would be pleased to consider with the Committee and the FCC whether a cap or other limitations on Section 1071 benefits would be necessary and appropriate to target more precisely this tax provision to its desired objective. We will also coordinate with other offices within the Administration, including the Commerce Department's National Telecommunications and Information Administration.

Overview of Section 1071

Section 1071 provides certain tax benefits (described below) to the seller of property if the sale or exchange is certified by the FCC to be "necessary or appropriate to effectuate a change in a policy of, or the adoption of a new policy by, the Commission with respect to the ownership and control of radio broadcasting stations." Since 1978, the FCC's policy has been to certify transactions as meeting this requirement where a sale of broadcast facilities is made to a minority individual or a minority-controlled entity.[1]

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[1] We understand that the FCC defines (1) a minority-controlled corporation as a corporation in which more than 50 percent of the voting stock is held by minorities and (2) a minority-controlled limited partnership as a partnership in which (a) the general partner is a

In general, Section 1071 allows a taxpayer to postpone the recognition of gain realized upon the disposition of certain broadcasting property for which the taxpayer has obtained the necessary certificate from the FCC (Section 1071 Certificate). The tax-free treatment accorded by Section 1071 allows the taxpayer to defer the tax on the gain realized in the transaction (although in certain circumstances such deferral can be effectively permanent). In this regard, the benefits of Section 1071 are generally similar to the benefits accorded taxpayers who reinvest insurance proceeds following an involuntary conversion of property under Section 1033 (e.g., as the result of fire or flood), or, to a lesser extent, taxpayers who participate in tax-free exchanges of "like-kind" property under Section 1031.

To obtain the benefits of Section 1071, the taxpayer must file an election with its return that includes the Section 1071 Certificate. This election requires the taxpayer to choose one of three alternative methods for taking advantage of the Section 1071 deferral. The first approach is to apply a modified form of the involuntary conversion rules. Generally, gain is not recognized to the extent that replacement property which is similar or related in service or use to the property sold is acquired before the end of the second full taxable year after the year in which the disposition occurs. The second approach is to reduce the depreciable bases of other assets held by the taxpayer at the time of the disposition and acquired before the end of the taxable year in which the disposition occurs. Unless the taxpayer requests an alternative allocation, the bases of all depreciable assets are reduced on a pro rata basis. The third approach is to elect a combination of the first two approaches (i.e., defer a portion of the gain through the acquisition of replacement property and another portion through reducing the bases of other depreciable property).

The Limited Role of the IRS

Under section 1071, Congress has delegated authority to the FCC to issue Section 1071 Certificates. Tax benefits under Section 1071 are available only if the taxpayer obtains a Section 1071 Certificate from the FCC. The IRS generally accepts as valid any Section 1071 Certificate that is issued. The IRS neither participates in, nor exercises oversight over, the FCC's determination, and conducts no independent inquiry into whether, for example, minorities meaningfully participate in a purchasing group. Consequently, the IRS's role is limited to administering and interpreting the technical requirements of Section 1071 described above (including the rules of Section 1033 which Section 1031 incorporates by cross-reference).

Potential For Abuse

I would also like to discuss the potential for abusing Section 1071, but first I should reiterate that the Department of the Treasury does not participate in the FCC certification process. My testimony therefore should not be construed as commenting on the propriety of issuing Section 1071 Certificates in any particular circumstances or for any particular transactions, including recent transactions that have been covered in the press.

Abusive transactions may arise in any regulatory context. As you are certainly aware, Treasury, the IRS, and the courts expend considerable energy and resources dealing with abusive transactions. Fortunately, the tax law, like other statutory regimes, is interpreted in a manner consistent with its spirit and purpose. Reflecting this rule of interpretation, tax doctrines have evolved to combat such abuses. These doctrines include a prohibition against "sham" transactions, a rule that a transaction must be taxed in accordance with its substance and not merely its form (the "substance over form" doctrine), and a rule that certain related transactions are to be aggregated and treated as one overall transaction (the "step transaction doctrine"). In addition, various statutory provisions and IRS

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minority or minority-controlled and (b) minorities own at least a 20 percent interest.

We also understand that the FCC generally requires those who acquire broadcast properties under Section 1071 to retain those properties for at least one year.

regulations have been adopted to address abuses because the common law doctrines have not been fully successful in combating abusive transactions.

Certification of transactions under Section 1071, however, is conducted by the FCC, and not the IRS. I assume that, like any regulatory agency, the FCC deals with attempts to abuse its rules, including the rules governing the issuance of Section 1071 Certificates. In the absence of adequate safeguards against abuse, it is possible that an aggressive participant could devise a scheme that might enable parties to obtain a Section 1071 Certificate even in situations that do not meaningfully enhance the ownership of broadcasting properties by minorities. If such a scheme were to succeed, granting the Section 1071 Certificate would unfairly reward the participants of a tax avoidance scheme, possibly at the expense of a bona fide minority ownership group and/or a non-minority ownership group that was unwilling to engage in abusive tax planning. Because the Treasury neither participates in nor reviews the certification process, however, I am not in a position to comment on whether there, in fact, exist any transactions where the grant of a Section 1071 Certificate is not consistent with the intent or purpose of Section 1071 or any regulations promulgated thereunder.

The issuance of Section 1071 Certificates is designed to further an FCC objective. Nevertheless, as I previously stated, we would be pleased to consult with the FCC or this Committee in developing further safeguards against abuse of the certification process (through anti-abuse provisions or specific measures such as a more stringent holding period requirement). We would also be pleased to work together towards other means of tailoring the Section 1071 benefits to more efficiently promote its objectives.

This concludes my remarks. Thank you once again for affording me the opportunity to testify. I am now available to answer any questions that the Committee may have.

Chairman JOHNSON. Thank you both for your testimony and also for your willingness to work with us on this issue to provide it with the oversight I believe it has needed and recreate for ourselves the authority that the legislature has traditionally had to oversee and adjust and clarify and modernize the law as circumstances change.

I would like to ask you, Mr. Kennard, in the background materials there is a chart that shows the number of FCC tax certificates issued for broadcast stations and cable television facilities from 1978 to 1994.

Up until 1987, there were, on average, something from the mid-teens to the low twenties in transactions. In 1986, there were 24. In 1987, there were 34. Then there were 34 for a couple of years and then it popped up to 42 and 43. Then it dropped back down in 1991 to 20 and the 11 and the high teens, a pattern of transactions that reflects the period from 1978 to 1986.

It is also interesting that the minority ownership data parallels the overall data. Would you comment on that explosion of transactions from 1987 to 1990?

Mr. KENNARD. I think it was a reflection of what was happening in the marketplace at the time. I was not in government at the time but was involved in a number of broadcast transactions, and I know there was a flurry of transactions that started in the mideighties and continued to the late eighties. Then, of course, we have had problems of recession in all of the communications industries and broadcasting was certainly not exempt.

I think those transactions that did take place in the early nineties, many of them were workout and foreclosure situations where there was no gain. So, accordingly, there would have been no need for a tax certificate. That is my best guess as to why there was a fall-off in the early nineties.

Chairman JOHNSON. Actually, it is in the late eighties you see this real explosion.

Mr. KENNARD. Then it fell off in the early nineties.

Chairman JOHNSON. So your response is that the activities of the late eighties was the consequence of the recession.

Mr. KENNARD. Yes, I think a lot of these deals were put into the pipeline starting in 1986 and 1987 and they were closing in 1988 and 1989. Then I think you see the effects of the recession hitting from 1990 to 1993 and there is a pretty significant dropoff after 1990.

Chairman JOHNSON. All right. Now, the FCC has a number of other ways of promoting minority ownership programs, and one of the ones that seems most interesting is their distress sale policy that allows a license that is approaching revocation hearings to be sold for substantially less than the fair market value if it is sold to a minority party.

How powerful has this been? How many transactions have there been under this distressed sale policy?

Mr. KENNARD. I think there have been approximately 30 or 35 transactions. We can get you the exact number in a moment.

Chairman JOHNSON. Over how many years?

Mr. KENNARD. Since 1978. I would say that it is an important—I was handed the exact number. It is 40 since 1978.

I would say that it is an important program but it has been of marginal effectiveness, principally because the only way that this program is triggered is if there is a licensee that gets in trouble with the FCC. Its license is designated for hearing. That licensee has a choice; either go through a full-scale administrative hearing, with all the expense and uncertainty that that process entails, or opt out for a distress sale to a minority owner at a below market price.

Two reasons why the program, I think, has had only marginal effectiveness: One is because there are just not that many designations of licenses for hearing; and second, those that get designated tend to be more marginal stations and not those that are the more attractive properties that would be important in promoting minority ownership.

Chairman JOHNSON. Thank you. That seems logical. It is interesting in that in the distressed sales situation, it is the licensee that takes the loss not the taxpayer. In other words, the person selling the station sells it below the market value, and so the minority incentive comes from the profit of the former owner rather than from the taxpayers. I think that is a significant and interesting difference.

What is your definition of minority?

Mr. KENNARD. Well, the FCC relies on the Federal statistics——

Chairman JOHNSON. Excuse me, minority control, I should say.

Mr. KENNARD. Oh, minority control, I am sorry. It is essentially the FCC looks at both de jure, that is legal, and de facto, factual control. The FCC has a lot of experience with this particular issue that far preceded the minority ownership policies with respect to the tax certificate. A lot of what the FCC does is license telecommunications facilities. So one of our central regulatory responsibilities is to ensure that we know who is controlling these licenses. So there are 60 years of case law and precedent that we rely on in determining whether a company or individuals are in control of a license.

Chairman JOHNSON. Well, generally, a minority-controlled corporation is one in which the minority owns 50 percent of the voting stock. A minority-controlled limited partnership is one in which the general partner must have at least 20 percent equity interest.

Now, if the Viacom deal that has received so much publicity is like other deals that have gotten tax certificates, there is neither the equity position nor the control position that are common to other minority-controlled transactions in other areas. Really, this has only been possible since 1978. So in this particular area, as distinct from other areas, how do you judge that minority control; and why is it that you have no statistics or data about what has happened as a consequence in however long control lasted?

You apparently have no information about whether when you granted a tax certificate the minority interest was sold 1 year after, 2 years after, 3 years after. So you have no oversight information from which we can evaluate the long-term impact on the goal of minority involvement in our communications system of this really very expensive, flexible policy of the FCC.

Mr. KENNARD. Let me answer your last question first. As I mentioned in my opening statement, we have looked at the average

holding periods of transactions involving the tax certificate. The average holding period is 5 years in most broadcast transactions. We do not have that information for cable. Again, we have been precluded by Congress from undertaking a wholesale reexamination of this policy. The legislation is quite clear on that point.

Chairman JOHNSON. Just for clarity, Mr. Kennard, what number of cable transactions have there been? What percentage of the transactions currently are cable?

Mr. KENNARD. Through the history of the cable tax certificate program, since 1982, there have been 30 cable transactions involving tax certificates.

Chairman JOHNSON. So it would not be an impossible task to research those and get appropriate information?

Mr. KENNARD. No, in fact the subcommittee has asked us and we are working on that matter right now.

Chairman JOHNSON. OK. Back to the issue of control.

Mr. KENNARD. Yes, the issue of control. To give you a little bit of historical perspective, when the Commission first adopted its minority ownership program in 1978, we adopted a very simplistic definition of control. We provided that if you are a corporate entity, you had to show that more than 50 percent of the voting stock was held by minorities.

When the FCC, under Chairman Fowler in 1982, convened another examination of the tax certificate policy, the marketplace had changed significantly and the FCC was kind of behind the times. A lot of deals were being done with limited partnerships, they were more highly leveraged transactions than we had been used to, so we adopted the policy with respect to limited partnerships to allow the policy to encompass and address the situation where you had a minority general partner who was in control of the enterprise but did not have over 50 percent of the equity. From that evolved this minimum 20 percent equity requirement in limited partnerships.

Now, that being said, I think that our knowledge of these deals has become increasingly more sophisticated, and in our minority ownership policies outside the tax certificate area, because again we have not been able to reexamine the tax certificate policy. But in other areas of our minority ownership policy, we have taken a far more sophisticated look at equity and defined minimum equity requirements for participating in these programs, looking at such things as profit and loss allocations as a determinant of equity ownership, liquidation preferences, and the like.

So it is an evolving concept, I think.

Chairman JOHNSON. It appears it does need to evolve in regard to these transactions.

We are going to start using the timeclock lights now, if we have that system lined up. It would be useful to us and I yield to Mr. Matsui.

Mr. MATSUI. Thank you, Madam Chairwoman.

Mr. Kohl, you have a $1.6 billion 5-year revenue loss for the program, apparently. It is my belief, and I would like you to perhaps take this back to Treasury, if you would not mind, and reestimate these numbers. Because it is frankly my belief that this is going to explode over the next 5 years, these kinds of transactions. I no-

ticed on a year-by-year basis that that is not necessarily demonstrated.

The reason I say this is that Viacom purchased Paramount Pictures and also Blockbusters. My understanding, again, because I do not have the ability to question the people involved in these transactions, Viacom had a cash-flow situation problem and that is why this transaction occurred. I would imagine with telecommunications exploding as it is, and with the whole deregulation of the industry, you will probably see a significant increase. So perhaps you might want to go back and reexamine this.

I have asked Mr. Kies to look at it as well. So I would just like you to do that. I have no further questions with respect to you.

Mr. Kennard, you indicated that in terms of broadcast, the average transaction is about $3.2 million; is that correct?

Mr. KENNARD. For radio, it is $3.5 million; for television, it is about $38 million.

Mr. MATSUI. For television, 38, but you have nothing on cable yet?

Mr. KENNARD. No.

Mr. MATSUI. You are able to do this even though you have the prohibition, appropriations prohibition?

Mr. KENNARD. Well, what we have done is we have just provided information that is a matter of public record.

Mr. MATSUI. I see just broad data. There is no analysis to it.

Mr. KENNARD. Right. We are providing the raw data.

Mr. MATSUI. OK, I would like to get back to the issue of control because that is a very important—by the way, do you have discretion to deny these certificates, or is it if they comply with whatever happens to be the regulations of the moment, you are obligated then to issue the certificate? Is that the correct understanding?

Mr. KENNARD. Yes, our understanding is that under our statute, Congress made it very clear that they did not want this policy to change from the way it was in effect in 1986. So since that time we have been applying the policy consistent with that congressional directive.

Mr. MATSUI. But you are obligated—as long as the minimum qualifications of the regs are fulfilled, you are then obligated to issue the certificate? You have no discretion once the terms are fulfilled; is that correct?

Mr. KENNARD. That is correct. Now, within those constraints, typically in these transactions, particularly the ones that are somewhat complex, the FCC staff spends quite a lot of time just trying to understand the transaction. So it is not a situation where someone comes in the door and certifies that he complies with the policy and a tax certificate is granted.

Mr. MATSUI. OK. Obviously, since the Viacom application is still pending, you have no idea whether you could or could not deny them a certificate, or whether you are obligated to grants it; is that correct?

Mr. KENNARD. My understanding is it has not even been filed with the agency as of this time.

Mr. MATSUI. OK. Let me get into the issue of control, because you said this is an evolving process.

I am trying to understand this, because, again, I hate to ask you, particularly, since you have the obligation of reviewing these things, but with respect to the Viacom situation, at least from what Mr. Kies has said, the 20-percent interest is satisfied but he was talking about a profit issue. In other words, he was talking about profit and losses. He was not talking equity interest, he was not talking about capital investment. It was basically the profit or losses he was speaking about in terms of the 20-percent interest.

Is that your understanding or do they have to have, the individual, have to have controlling interest or some kind of controlling interest or management interest in the venture?

Mr. KENNARD. Our threshold review is to determine whether the minority principals have control of the enterprise. That is, we start by analyzing the documents to make sure that the documents vest legal control in the enterprise in the minority principals. If it is a corporation, such things as the ability to hire and fire, elect a majority of the board of directors, things such as that.

Now, when it comes to equity, in a limited partnership——

Mr. MATSUI. If I can just finish off and ask a further question. I don't mean to interrupt you.

Mr. KENNARD. Certainly.

Mr. MATSUI. In other words, then, the individual, the minority participant must have a controlling interest. He or she will be in a position to fire, hire, make all of the decisions of that company that is purchased or that is——

Mr. KENNARD. That is our requirement. We look at such things as the ability to control budgets, to select programming, hire and fire key personnel. Those are kind of the bedrock attributes of control that we look to.

Mr. MATSUI. So the transactions that Mr. Johnson referred to, presumably the minority contractor has absolute control over all those management decisions, the programming and all that, as well.

Mr. KENNARD. Yes.

Mr. MATSUI. OK. You wanted to finish in terms of the equity interest.

Mr. KENNARD. Yes, I did just want to clarify that when it comes to equity, it is often difficult and I think the tax lawyers in this room would probably confirm this, it is often very difficult to define what equity means, particularly in the context of a complex partnership.

So what we have done at the FCC is we have required that individuals requesting tax certificates for a limited partnership deal demonstrate that the minorities in the deal control not less than 21 percent of the equity in the venture. In some of the other areas of our minority ownership policies, we have started bringing more sophistication into this analysis looking at such things as profit/loss allocations and liquidation values and the like.

Mr. MATSUI. If I may follow up on that, because you say, then, that if—I will use a hypothetical—if the minority contractor put $1 million on a $2.3 billion transaction, he then presumably, in order to fulfill your requirements of a 21-percent-plus equity interest in the venture, would then automatically have a $400-plus million eq-

uity interest? So if he sold the venture 13 months later, he would be able to reap a profit of——

Mr. KENNARD. Not under the tax certificate policy, no.

Mr. MATSUI. I thought that is what you said. Maybe I misunderstood you.

Mr. KENNARD. I am sorry if I am confusing you. Under the tax certificate policy, the Commission looks to see whether the minority principals have control, No. 1, and No. 2, in a limited partnership that they control—usually it is through a corporate general partner—that corporate general partner controls not less than 20 percent of the equity in the venture.

That does not mean that the minority individual has personally a 20-percent stake in the venture. But they control an enterprise which in turn controls not less than 20 percent.

Mr. MATSUI. That is why—now I kind of understand why this deal was structured the way it was. There was a number of different corporations and a number of different limited partners—well, there was a major limited partnership. But that is the way to maintain the control over the entity itself but not have necessarily an equity interest in the investment.

Mr. KENNARD. Yes.

Mr. MATSUI. OK.

Mr. KENNARD. In another context where we have defined minority ownership more recently, we have departed from that and said tell us how much equity the minority principals personally have in the venture. So it is a slightly tougher and different standard.

Mr. MATSUI. Well, it sounds to me like—well, I have nothing further.

Thank you very much.

Chairman JOHNSON. Before I recognize the next member of the subcommittee to question, I had not quite coordinated in my own mind the relationship between the Appropriations Committee language and the chart reflecting increased activity in 1987. The statutory language prohibited the spending of any appropriated funds to repeal, to retroactively apply changes in, or to continue a reexamination of its policies with respect to tax certificates granted under 1071.

So, apparently, we suspended any review that you were doing. The very year we did that, the number of tax certificates exploded.

Now, you had suggested that the explosion was the consequence of the recession and the deals that came to fruition, which undoubtedly was a factor. But it is very interesting that the Appropriations Committee action and the number of deals done do relate, and if you do not have the detail on the interrelationship now, it is certainly necessary for this subcommittee to understand that relationship.

Can you point to issues that were being reviewed by the Commission at that time that might have had to do with fraud and abuse or with an appropriate use of tax certificates, that when denied the right to exercise any judgment over whether the policy you had in place was reasonable and necessary or appropriate by the Congress, the numbers of deals exploded?

Mr. KENNARD. Well, I don't know if there was a causal relationship between those two events. It is really hard to speculate. I was

not at the agency at the time. I have researched the history and I know in 1986 the Commission commenced a proceeding to reexamine and reevaluate this particular policy.

Chairman JOHNSON. Do you know why the Commission commenced that reexamination?

Mr. KENNARD. From what I can gather at the time, the Commission wanted to take a look at both the constitutional and policy justifications for the policy in a rulemaking proceeding that was commenced in 1986.

Chairman JOHNSON. Would you look back on that in greater detail and report back to us?

Mr. KENNARD. I am not sure I understand precisely what your question is, Congresswoman.

Chairman JOHNSON. I want to know what were the red flags that led the Commission to realize that they perhaps ought to look at this. Is there a relationship between the questions that they were asking, the decision of the Congress to stop the reexamination, and the increased number of tax certificates granted? Because in earlier testimony, it has been clear and it has been your policy that if a deal meets the minority participation standards, you do not look at the tax consequences as a factor. That does not weigh in as to whether the deal is eligible.

Mr. KENNARD. We are not permitted to.

Chairman JOHNSON. Right. But it is important for us to know what the controversy was at that time that led to an appropriations rider and the relationship between that rider and the activity in this program. So if you could look back on that in greater detail and get back to us, I think it would be useful to us.

Mr. KENNARD. I would be happy to. At this point I am speculating, but there were a number of events in the industry at the time that contributed to an increase in the number of broadcast transactions. One is the one I mentioned, that the economy was stronger and the broadcast industry was feeling the effects of that.

Also, the Commission at the time had deregulated a number of its ownership rules. It had, for example, repealed a rule that required owners of broadcast stations to hold them for 3 years or more, and that contributed to a lot of interest in the broadcast marketplace by the lending community. I think that may explain why those numbers spiked, but we will be happy to look into that and report back to you.

Chairman JOHNSON. Thank you, I appreciate that.

[The following was subsequently received:]

FEDERAL COMMUNICATIONS COMMISSION
WASHINGTON, D.C. 20554

June 23, 1995

OFFICE OF GENERAL COUNSEL

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VIA COURIER

Ms. Traci Altman
Committee on Ways & Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Traci:

Per your fax to my office of June 12 concerning information promised to the Committee during my testimony on January 27, 1995, I am enclosing the following materials:

1) Chairwoman's Johnson request

Chairwoman Johnson requested greater detail on the circumstances resulting in the FY 1988 appropriations rider that barred the Commission from examining or changing its policies fostering ownership of broadcasting licenses by women and minorities. I enclose the relevant pages from the Senate Report and the Conference Report on the appropriations bill, Senator Lautenberg's comments on the Senate floor concerning the bill, and the applicable provisions from the Public Law. These documents should help to illuminate Congress's thinking when it enacted the ban.

2) Congressman Hancock's Request

Congressman Hancock requested information to assess whether certain individuals had repeatedly used the Commission's minority tax certificate program. Between 1978 and 1994, we have identified 44 sellers of broadcast and cable facilities who benefitted more than once from the tax deferral conferred through the program. Also during that period, we have identified 46 minority individuals who on more than one occasion purchased broadcast and cable facilities with the assistance of the tax certificate program.

3) Congressman Zimmer's Request

Congressman Zimmer requested information on the number of tax certificate transactions involving former Commission personnel. As I explained during the hearing, the Commission does not ask for the personal histories of those requesting tax certificates.

I trust this information is responsive to the Committee's request for further information. Should you have additional questions, please call me on 418-1700.

Sincerely,

William E. Kennard
General Counsel

Enclosures

cc: Judy Harris
Anthony Williams
Robert Calaff
Brian Browdie

[Attachments retained in Committee Files.]

Chairman JOHNSON. I will now recognize Mr. Herger.

Mr. HERGER. Thank you very much, Madam Chair.

Mr. Kennard, if I could follow up on a question I asked earlier of Mr. Kies having to do with how you adopt your policies on how the FCC determines which minority group should be entitled to tax certificates or other preferences.

To be specific here, according to a recent article in Forbes Magazine, Storer Communications recently sold one of its stations to the Liberman family. Apparently, this family qualified as a minority because it was able to demonstrate that the family had been expelled from Spain by King Ferdinand and Queen Isabella during Spain's purge of its Jewish population in 1492.

The FCC represented to us that it approved the tax certificate because the family was able to demonstrate that it was actively involved in the Hispanic community. Could you comment on that, please?

Mr. KENNARD. Certainly. I think that article is somewhat misleading. I am familiar with the case. First of all, the FCC relies on the definitions of minority promulgated by the Office of Management and Budget. These are the definitions that OMB uses for all of the Federal statistics and program administration in this area.

With respect to the Storer case, the article is a little misleading because OMB defines a Hispanic as someone of Hispanic origin. It is true this family apparently had origins in Spain many years ago, but the family emigrated to Mexico in the 1920s and then to the United States. They were able to demonstrate to the FCC that they were of Hispanic origin, they were active in the Hispanic community, they spoke Spanish in the home. The FCC got evidence from the Department of Commerce's Minority Business Development Agency to determine that, in fact, this family was a recognized, leading family in the Hispanic community.

So there was—the article is a little misleading to suggest only that they had origins in Spain in the 15th century.

Mr. HERGER. Well, I appreciate your clarifying. That does make it a little better. But again everything we are hearing today does indicate or would appear to indicate some, to say the least, some very poor policies, I would say, in being fair with all taxpayers. As I travel around my district, constituents who come to me indicate over and over again that they do not mind taxation so much as long as they are treated fairly, as long as everyone is treated the same way.

I would have a question of you, Mr. Kohl, if I could, and that is, in your opinion, when we begin—when we hear of some of the outrageous examples, as we have been hearing throughout this morning, throughout the testimony on this particular issue that we are on, I guess my question is are we not leading up to this—do we not lead our Nation's tax attorneys into creating these type situations when we set up policies that would somehow set out one group over another as dealing with them, say in a more positive way than others?

Mr. KOHL. Mr. Herger, I have been a tax lawyer for a long time, mostly in private practice, and I do not think the problem is section 1071. I am personally thrilled to hear you mention that issue, be-

cause some tax lawyers have a real problem with distances—you give them an inch and they take a mile.

We have reports of many abusive transactions. Rent-a-partner schemes, which I cannot comment on whether they exist in the FCC context, but rent-a-partner schemes that exist in the law that we are trying to combat exist everywhere. There are reports of business ventures where you bring in a foreign partner for a year or two, accelerate and allocate the income to a foreign partner, and then the foreign partner leaves and you are left with a business venture that did not pay any U.S. tax, plus they are left with deductions.

So I am thrilled to hear that we have to deal with a tax abuse problem, because I do think it is a matter of fairness and I think if we do not address it, I do think it affects ordinary citizens, who start to feel like chumps, as other people who are willing to be aggressive take aggressive positions.

So I agree wholeheartedly, but it is certainly not limited to section 1071. There are many areas where we should look at this and we would love to work with the subcommittee to address these.

Mr. HERGER. Well, I want to thank you. Again we have heard specifically one individual. I have to believe there is more, specifically Mr. Washington. It is not just his deal here.

We are hearing there are other deals as well where this one minority individual, not an entire minority but one individual, I could see where other minorities would feel like, boy, this is not fair. Why is this one individual making millions? We are not able to.

Again, I get back to the question, perhaps the policy where somehow we are setting one group out, favoring them over another, are we not setting up an environment where we are actually either purposely or nonpurposely creating an environment where this becomes the norm rather than an exception?

Thank you.

Chairman JOHNSON. Thank you. Mr. Hancock.

Mr. HANCOCK. Thank you very much.

Mr. Kennard, did I understand you when you mentioned a 21-percent minority ownership, but not necessarily any equity investment by that minority individual? He qualifies as long as he has control of that 21 percent, even though he did not put any equity in himself?

Mr. KENNARD. That is essentially correct. The FCC staff, based on our case law under section 1071, looks to see that the minority principals do have a meaningful or significant economic stake in the venture. But that has not been defined precisely and the Commission, again, has not been permitted to go back and commence a rulemaking proceeding to flesh out in more detail what that means.

Mr. HANCOCK. Well, from what you are telling me, it means that if an individual wanted to get a tax certificate of some type, all he has to do is just find a straw partner that happens to be a minority.

Mr. KENNARD. Well, one, I don't think there is rampant abuse of this policy; and, second, there are incentives here. The purpose of the policy is to create incentives to get minority individuals into business.

Mr. HANCOCK. I understand the purpose but I also know the use of the minority situation can benefit people that are not minorities, and it seems in this situation that that is what is happening.

Mr. KENNARD. The only point I wanted to make, sir, is if you were to require the minority principals to make pro rata contributions based on their equity holdings, that amount of money would be prohibitive for most minorities in this country and you would not—the policy would be useless because you would not be able to bring many minorities into these deals.

Mr. HANCOCK. All right. Well, we can discuss that one for quite a while, too.

I asked Mr. Kies earlier about the information on the 378 tax certificates that have been issued since 1978. He indicated that he had been trying to get information or had started trying to assemble the information on that in the past 2 weeks, and I would appreciate it if your organization would assist him in assembling that information so we can get some specific details, case by case, if nothing else a random sampling, say, of 20 percent of them, or let us go 21 percent, that sounds like a good round figure, of just a random sampling of those so we can look and see. I want to know if there has been duplication. In other words, have there been cases where certain individuals have repeatedly used this same program.

I think we have one example, but I want to know if there are some other examples, and I would appreciate it if you could work to get that information available for him or for us as quickly as possible.

Mr. KENNARD. We would be happy to continue to work with the subcommittee in that regard.

Mr. HANCOCK. Thank you.

[Refer to the responses on page 58 of this hearing.]

Chairman JOHNSON. Mr. McDermott will inquire.

Mr. MCDERMOTT. Thank you, Madam Chair.

Mr. Kennard, I looked at the statutory language and it says radio broadcast systems. How did we get into television?

Mr. KENNARD. Well, in 1958, as I recall, the Congress specifically defined that term to include telecasting.

Mr. MCDERMOTT. So, something was done elsewhere in the Tax Code?

Mr. KENNARD. I believe there were some technical amendments to the code.

Mr. MCDERMOTT. Let me ask you another question. In your testimony, you have four categories: minority ownership, owners of AM radio, microwave licensees, licensees to come into compliance. These are the other areas where you grant these tax certificates.

Mr. KENNARD. Yes.

Mr. MCDERMOTT. How many of those have you granted?

Mr. KENNARD. Approximately 115.

Mr. MCDERMOTT. In those other three categories?

Mr. KENNARD. Yes, that is correct.

Mr. MCDERMOTT. If we wipe out 1071, we take them with us?

Mr. KENNARD. Certainly if 1071 were to be repealed, the Commission would not be able to grant tax certificates in these other areas as well; that is right.

Mr. MCDERMOTT. There have been a couple of terms thrown around here, and I have gotten to listening to words: Sham and abusive, sham relationships, abusive relationships. Do you have definitions either at Treasury or at FCC about what is a sham relationship or what is an abusive relationship?

Mr. KENNARD. Well, I think it is the same thing, but we define it more in terms of an abuse of process or an unauthorized de facto transfer of control. That is, if someone represents to us that one entity or individual controls an enterprise and really somebody else does, we define it as a de facto transfer of control. It is a violation of our rules, and we have the ability to take punitive enforcement action against that situation.

Mr. MCDERMOTT. Is that arguable in court? If I have one of these certificates and you come in and say, no, you are violating the rules, where do I go for adjudication of that?

Mr. KENNARD. Well, if it is discovered that someone sought a minority tax certificate and it was based on misrepresentations, that licensee's license would be at risk. They would subject themselves to the full panoply of the Commission's enforcement authority. That includes fines and forfeitures, designation for hearing, and eventual revocation of license and such.

Mr. MCDERMOTT. OK. Let me ask another question. I am interested in this business about who owns something. Let us suppose that a Southeast Asian came into this country as a legal immigrant—I emphasize the word legal—so they are now legally an immigrant and they gather together some money and they want to get involved in buying a radio station or want to get in one of these deals. How do you decide whether or not they have enough money invested in this to do it?

Mr. KENNARD. Well, we do not look to see whether they have enough money invested in the deal. We look to see whether they have sufficient equity to satisfy our control requirements. As I was saying earlier, in many of these deals, both in the minority and nonminority context, the promoters, the people who put the deal together often bring little money to the table, but they are able to leverage their ideas and their willingness to work hard and to put the deal together into an equity position. There is nothing unique about minority ownership.

Mr. MCDERMOTT. Being a legal immigrant would not be a problem? You do not have to be a full citizen to own a radio station?

Mr. KENNARD. Well, yes, you do, under a section in our act, the FCC cannot grant broadcast licenses to foreigners or representatives of foreign governments.

Mr. MCDERMOTT. If they are a legal immigrant, they are not eligible to own a station?

Mr. KENNARD. They would have to be U.S. citizens.

Mr. MCDERMOTT. Some, if they are in the process—if they get to be a naturalized citizen, then they can own?

Mr. KENNARD. That is correct. That is the case of Rupert Murdoch, who became a U.S. citizen to buy broadcast properties here in the United States.

Mr. MCDERMOTT. Can he be a citizen in more than one place?

Mr. KENNARD. I suppose so, but I am not sure. As long as you are a U.S. citizen, I believe you comply but I am not certain.

Mr. MCDERMOTT. You do not look beyond that. You do not look at whether he has three citizenships, one in Britain, one here, and one in Australia to qualify for things in three different places?

Mr. KENNARD. It has not come up in my practice, no.

Mr. MCDERMOTT. Now, let me ask about this equity business. If I come to the table with $1 million in cash, and there are probably some members here who could get into one of these deals.

People have said this deal is not very substantial. A million bucks sounds like a lot of money. I could not get into a deal, bring in $1 million to the table. I also could bring a tax certificate in my other pocket worth $400 million to the people who were buying it, or selling it to me. How do you evaluate that as what I am bringing to the table in the deal?

Mr. KENNARD. Well, we would want to make sure that in a deal like that we would very carefully scrutinize all of the documents to make sure that you had, if you were representing that you controlled a 21-percent equity interest in the deal, that you really did control it.

We cannot really get into valuing your relative contribution versus the investors, because that is a determination I don't think an administrative agency is really equipped to do.

Mr. MCDERMOTT. How do you decide that I have 21 percent of control? Is it that on Mondays I make the decisions and they make them on Tuesday through Friday?

Mr. KENNARD. No, you have to—control to us means that you have to have all the indicia of someone who controls the business. That is you elect the members of the board, you make the hiring and firing decisions. That cannot be diluted by clever supermajority provisions that give the investors the ability to effectively dilute your ability to make those decisions.

Mr. MCDERMOTT. But 20 percent is not enough to control everything. That is obviously one-fifth; right?

Mr. KENNARD. We draw a distinction between equity ownership and control.

Chairman JOHNSON. Excuse me. Would the gentleman yield?

Mr. MCDERMOTT. Yes.

Chairman JOHNSON. I am going to recess the subcommittee when the gentleman is done questioning. He can proceed as long as he feels he can. But in order to minimize the recess, I am going to go vote.

Mr. MCDERMOTT. OK. The control issue—it is 100 percent control.

Mr. KENNARD. Right; 100 percent control but not less than 20 percent equity. Control of equity. So we draw a distinction——

Mr. MCDERMOTT. Not being a lawyer, I have a lot of fun trying to figure out how your minds work because you can really slice a piece of baloney in some real thin slices.

I see that I am in charge of the subcommittee here and I will adjourn it for 10 minutes.

Mr. KENNARD. Thank you.

[Recess.]

Mr. ZIMMER [presiding]. Please be seated. We are reconvening the session. The chairwoman has asked me to continue the hearing

until she gets back from the vote, so I will ask a couple of questions at this point.

We will start off with Mr. Kennard. Mr. Kennard, how many of the tax certificates you discussed today involve participation by current or former FCC staff members? Mr. Kies told us that Mr. Washington, who is involved in the Viacom transaction, actually devised the current policy. How many other former FCC staff members or Commissioners have been involved?

Mr. KENNARD. Well, it is difficult to say definitively because we do not compile information when people come in and ask for a tax certificate. We do not ask them if they have worked for the agency before. So all I will say is what I know kind of anecdotally.

I know Mr. Washington did work at the FCC for a time in the early eighties. I think he left before the current policy came into being. That is with respect to cable television and limited partnerships that we are talking about today. I am only aware of one other individual who benefited from the policy, that is a minority principal who benefited from the policy, who had some former contact with the FCC, and that was a gentleman by the name of McKee, Clarence McKee.

But I might add that having worked at the FCC now for a little over 1 year, I am finding it is not at all unusual for people who come to the FCC, learn about our rules and policies, become expert to go out in the private sector and basically take advantage of the knowledge. That is certainly their right.

Mr. ZIMMER. It certainly is. I am concerned about, however, the problem of the revolving door in government in general, and I have introduced legislation dealing with the problem in Congress specifically, where people come back and it is not on the basis of what they know, but rather who they know that they are able to get access and influence, so I do believe it is a serious concern.

You had mentioned in passing in your own testimony that you had some involvement in FCC transactions before you came to the Commission. Were you involved in any that had tax certificates as part of the——

Mr. KENNARD. Yes, before I went into government, I was a communications lawyer in Washington for a dozen years or so, and like many communications lawyers in this town, I was involved in tax certificate deals both from the buyers' and the sellers' perspective.

Mr. ZIMMER. Is it possible for you to get us information at a later date in writing as far as the number of those tax certificate transactions that did involve former FCC personnel?

Mr. KENNARD. Congressman, really, I do not know if we have that data. Again, we do not ask for a personal dossier on people who come in and request tax certificates, nor do I think that we could actually identify every principal who was involved in one of these deals.

Are you asking for information with respect to just the minority participants or the nonminorities who may have benefited from the tax certificate as well?

Mr. ZIMMER. Both.

Mr. KENNARD. Both.

Mr. ZIMMER. Because the testimony here has been that the nonminorities get the major benefit.

Mr. KENNARD. Again, I don't believe that we have all that information, but I will confer with the staff to see if we can provide it.

[Refer to the responses on page 58 of this hearing.]

Mr. ZIMMER. In your initial testimony, you also said that you thought there was room for improvement in the program. I know you are constrained in some respects by the appropriations rider. How would you like to see the program improved?

Mr. KENNARD. Well, I think there are a number of things that we have done in other contexts at the Commission that would certainly benefit the tax certificate program. One area that I think bears some looking at is the holding period, perhaps extending the 1-year holding period to something longer than that. As I mentioned earlier, we developed a lot more sophistication about assessing equity and minimal equity requirements, and I think that probably bears some study.

In some of the other areas, we have also taken a hard look at how options and warrants are treated and we don't allow, for example, minority principals to option or sell a future interest in their equity in the deal. That is one area that I think bears some further study.

Mr. ZIMMER. Thank you.

Do you have any studies that indicate that minority ownership has resulted in different programming by the stations that are minority owned as a result of that ownership, empirical evidence shows that there is different programming?

Mr. KENNARD. There is actually a lot of empirical data developed by both government and the academic community. Probably the most notable one was a study that was done by the Congressional Research Service in 1988. With the cooperation of the FCC there was a survey taken of some 8,000 broadcast stations to determine whether there was a nexus between minority ownership and programming directed to a minority audience. They found a strong correlation between those two factors.

Mr. ZIMMER. Did that study focus on the type of ownership by the minority, for instance, what Mr. Kohl referred to as rent-a-partner situation? Was there a difference between owners that were only nominal owners where the vast majority of the capital came from nonminorities versus owners who had not only nominal or legal control but the majority of the equity?

Mr. KENNARD. As I recall, Congressman, the study focused on minority control, and they looked at stations that were, or certified they were, minority controlled and compared the amount of minority oriented program developed by those stations or aired by those stations compared to stations that did not have minority control. They found that with respect to African-American stations, for example, 65 percent of those stations that were controlled by African-Americans provided significant minority programming, whereas only 20 percent of stations that were nonminority controlled provided significant minority programming. Similar numbers were developed with respect to Hispanic ownership as well.

There have also been a number of studies to show that minority-owned stations tend to employ minorities in higher numbers, which is also an important policy goal of the Commission.

Mr. ZIMMER. Mr. Kohl, do you have your most current estimate of the tax expenditure involved with this tax certificate program?

Mr. KOHL. I believe Treasury comes in at about $300 million a year, Joint Committee comes in at $100 million a year.

That was, I think, referred to in the preparation of last year's budget.

Mr. ZIMMER. You don't have any more current information?

Mr. KOHL. No.

Mr. ZIMMER. The Viacom transaction aside, you don't have any reason to doubt the magnitude of those estimates?

Mr. KOHL. I think estimates are just that and they are based on information available at that time. I think as new information develops and if there were an unprecedentedly large transaction to occur, or perhaps in light of Mr. Matsui's observations over time, I think the estimates could change but I really can't comment on the estimate made at that time.

Mr. ZIMMER. Do you know if your estimate takes into account the FCC's recent expansion of the tax certificate program to include personal communications services?

Mr. KOHL. I do not know if it does. I do think the estimate is prepared in consultation with the FCC, but I don't know if it does or not.

Mr. ZIMMER. A final question of Mr. Kennard. I can understand how programming considerations would be important with respect to minority ownership of radio and TV. What is the social purpose behind the same incentives being given for personal communications services?

Mr. KENNARD. Well, in the personal communications service, there again Congress mandated in the 1993 Budget Act that the FCC ensure that there were opportunities for four categories of licensees to get into this business—minorities, women, small businesses, and rural telephone companies.

I think the concern there was that Congress was authorizing the FCC to conduct spectrum auctions for the first time. Prior to that, as you may know, the FCC gave away licenses for free, and commencing last year the FCC decided, with the authority of Congress, to auction spectrum for the first time. There was concern that if the FCC didn't have some sort of incentives to diversify ownership because people were paying for licenses, they would all end up in the hands of the established industry giants. So it is more diversification of ownership as an economic basis as opposed to a programming diversity rationale.

Mr. ZIMMER. So it was a different philosophical basis, more of a standard set-aside, rather than to have diversity in communications?

Mr. KENNARD. It would not have been a set-aside because the Congress did not mandate a set percentage of minority or women ownership.

Mr. ZIMMER. More like an affirmative action program then?

Mr. KENNARD. Yes. Right.

Mr. ZIMMER. Thank you.

Mr. Levin.

Mr. LEVIN. Thank you.

You were asked what recommendation you might have. Could I probe a little further than that. You mentioned several areas. You work with the laws and you see how they are implemented.

Do you have any other suggestions? For example, should there be some changes relating to the size of the transaction, the amount of the tax advantage that would be created?

Mr. KENNARD. First, let me say that I am constrained because of our appropriations language in my ability to conduct here or at any time a wholesale reexamination of this program. All I meant to suggest to Mr. Zimmer was that there are differences between the minority ownership program that we administer here and elsewhere, and the comparison might suggest ways to improve the tax certificate policy.

But to get to your specific question, I think that it is certainly a legitimate issue to put on the table and examine to see—kind of analyze the cost-benefit relationship between the benefits of diversity and the cost to the U.S. Treasury.

Mr. LEVIN. Obviously, I don't want to press you beyond your discretion here and you will be very discreet about that, but I think I hear you. It is legitimate for this subcommittee and committee and the Congress to look at cost-benefit analyses which would include taking into account the size of the transaction and how much that might be relevant to the benefit of the stated purposes of the program.

Mr. KENNARD. I think those are all legitimate questions to ask.

Mr. LEVIN. Do you think from the experience within the Commission there is legitimate reason for us to have concerns in that regard?

Mr. KENNARD. No, I really don't because I think that by and large these transactions are quite small, and I think if you are going to ask the question of getting into the cost-benefit analysis, you are really talking about a handful of deals and certainly not the majority of tax certificate transactions.

Mr. LEVIN. Well, but that I think is even more of a reason to look at the large ones.

Mr. KENNARD. Perhaps so.

Mr. LEVIN. I will leave it at that. Thank you.

Mr. ZIMMER. Mr. Rangel.

Mr. RANGEL. Thank you, Mr. Chairman. I came here for the sole purpose of introducing my dear friend Percy Sutton to the Ways and Means Committee, but I am so fascinated by the accomplishment of this Frank Washington who seems to have been so successful in allowing viewers to get a view of all Americans, including African-Americans, and it seems as though he has caused quite a bit of disturbance among some Members of Congress, this gentleman, Mr. Washington.

How many of these tax certificates have been issued to him in these so-called deals that we have been talking about?

Mr. KENNARD. I believe that he has participated in five such deals.

Mr. RANGEL. Now, in those five deals, how many of those deals is he the minority controller and in charge of?

Mr. KENNARD. All five. Presumably if he received tax certificates in five deals, the Commission certified that he controlled all of those deals.

Mr. RANGEL. So he has not been a front for anybody. He has done what the legislature tried to do, that is, to get diversity in terms of the ownership of broadcasting?

Mr. KENNARD. That is correct. At the time that the FCC looked at his deals, they were able to certify that they were minority-controlled deals.

Mr. RANGEL. Now, most of the time that I ask questions I know the answer, but this time if this Frank Washington got five deals and he is in charge of five majority holdings—and I assume they are sensitive to the needs of minorities—what is the big deal about Viacom?

Mr. KENNARD. Congressman, I really can't answer that question today because the Viacom transaction has not been filed at the FCC. We anticipate that it will be, based on the press reports that we have seen. When it is filed, the FCC will closely scrutinize it, as it does all the tax certificate requests, and I really don't think it would be appropriate for me to prejudge what the agency would do or what I would do, because I may be a decisionmaker in the matter.

So I really don't think it would be appropriate for me to answer the question.

Mr. RANGEL. Up to now there is not a scintilla of evidence, in your opinion, that Mr. Washington abused the system?

Mr. KENNARD. That is correct.

Mr. RANGEL. Thank you.

Chairman JOHNSON [presiding]. Thank you. I know Mr. Matsui has a question.

Mr. MATSUI. I know these gentlemen have to leave in 1 minute.

Mr. Kennard, I am still on the control issue because I think that is a significant issue. You were saying that it is an evolving matter as well.

How do you determine the control? I understand that 50 percent—you have to have management control of programming, programming control, the individual minority participant. How do you make that determination? Is it on the four corners of the paper, the application that is submitted, or is there an interview process with, for example, TCI in this case, or how does that actually—how was that done?

Mr. KENNARD. Typically, the parties file the request and the FCC staff asks for all the documents governing the deal. The purchase agreement for the systems, all the various financing documents, the limited partnership agreement is always key; and they analyze those documents and invariably in the more complicated ones the parties come in and they are questioned by the staff, and there is kind of a give and take so that the FCC can understand how the documents work and who has control.

Mr. MATSUI. I would imagine the financial interest of the minority applicant or participant is a consideration as well; in other words——

Mr. KENNARD. It is typically a prime consideration, yes.

Mr. MATSUI. Sorry.

Mr. KENNARD. It is typically a prime consideration.

Mr. MATSUI. That is interesting. So, in other words, it is—when you say "prime consideration," that means that it is a—again, I am trying to understand this—it is a significant issue in terms of the variables that you decide before you make the determination that the minority participant is in fact in control of the programming, the hiring and firing, and members of the board of directors, the purchase of other outlets or whatever the issue may be.

Is that correct?

Mr. KENNARD. That is correct.

Mr. MATSUI. So if a person has a 1/260th—no, 1/2600th of an investment, that would be a significant consideration?

Mr. KENNARD. It is a little bit confusing because you have to separate debt from equity. Often in a transaction that is fairly highly leveraged, a lot of the money will be coming in in the form of debt. You can't really assess what the equity holdings are until you look at that separately from the debt. So you can't just look at—if the total amount of the deal is $10 million, you can't look at what the general partner's contribution is and say it is $1 million, and it is a one-tenth interest.

Mr. MATSUI. I understand that, but you would have to assess what that individual's debt obligation is as well.

Mr. KENNARD. Yes. That is correct.

Mr. MATSUI. If the press reports show he has a $1.3 million obligation and the other partner, limited partner, has a $2.1 billion obligation, I would imagine that that would also be a factor in your ultimate determination about controlling interest as well.

Mr. KENNARD. That is right. Another thing we look at is how the minority principals are getting the money to put into the deal. If, for example, a minority principal is putting in, say, $10 million into a deal but borrowing it from the investors and there might be some restrictions in that loan agreement that effectively allow the investor to control the minority principal, that is something we would not permit and would look at very closely.

Mr. MATSUI. Are these parts of the regulations? In other words, you have specific language in the regulation, or is this very discretionary?

Mr. KENNARD. It is based on some decisions and all the various tax certificates we have granted, but also internal staff guidelines that have been developed.

Mr. MATSUI. Are those in writing?

Mr. KENNARD. I don't believe so. Some of them may be, but I would have to check on that.

Mr. MATSUI. I guess, in addition to the amount involved here, another consideration has to be—again, when you answered my question at the outset, it was that you have no discretion once the terms are complied with, it becomes a ministerial function on the agency's behalf.

On the other hand, there seems to be so much discretion built in, particularly if they are not in writing, that it is a discretionary action on behalf of the FCC.

I guess what troubles me is that, is that a proper delegation of a function of the legislative branch of the government? It would be one thing if we are talking about 1 or 6 million dollars' worth of

tax breaks, but potentially $600 million, it becomes a very, very interesting issue for us. Is that properly delegable?

I appreciate this, and I just hope that we are going to be able to allow you to do some analysis and investigation of this matter. I appreciate the fact that you are hamstrung now because you can't even give us any data or analysis as to whether this program is successful or unsuccessful or moderately successful because of the appropriations letter.

It is a shame that a group of attorneys must have gone to the Senate and had this provision put in the appropriations bills over the last few years.

Mr. KENNARD. I hope we will have that opportunity as well.

Mr. MATSUI. Thank you.

Chairman JOHNSON. I thank the panel for your input. I look forward to working with you. This represents an opportunity for us all, and we do need you to get back to us promptly both with the information that we have talked about over the course of the hearing and that you have been talking about with the staff, and also any recommendations you would want us to consider as a proposal to amend this law.

Mr. KENNARD. I'd be happy to do that.

Chairman JOHNSON. Thank you.

Chairman JOHNSON. We are going to go to the next panel and because of the timeframe and the fact that floor votes will conclude by 3 o'clock and many members have planes thereafter, we are going to try to move right along.

I am sorry that the initial panels have taken so long. I apologize to those in the latter panels but it is our opportunity to get the fundamentals firmly in mind.

On this panel, we have Bruce E. Fein, Great Falls, Va., attorney in constitutional, civil rights, and telecommunications law, and former general counsel of the FCC; J.D. Foster, executive director and chief economist, The Tax Foundation; James Gattuso, vice president for Policy Development for Citizens for a Sound Economy; and Bruce R. Wilde, Esq., Rogers & Wells.

I am going to recognize as the panel assembles, our colleague, Mr. Rangel, who has had the opportunity to join us for a few minutes here and would like to exercise a point of personal privilege before he has to return to his own hearing before the Human Resources Subcommittee.

Mr. Rangel.

Mr. RANGEL. Madam Chairlady, let me thank you for this courtesy that you have extended to me to introduce my long and dear friend Percy Sutton.

When I first started getting calls from constituents that a minority ownership in broadcasting was going to be in jeopardy, I tried to find out what subcommittee it was; and when I found out you were the chairperson, it reminded me of your freshman year here when one of the first pieces of legislation that you introduced was a bill to provide a monument for the black patriots of the American Revolution.

Since that time, I have had an opportunity to serve with you on problems that concern the poor, the aged, the disabled, and clearly

you have gained a reputation of voting for your conscience and not by party.

So as we come here with the Contract With America, I am impressed that the majority party intends to save money, build equity, and move forward to create jobs to make America more productive.

One of the more interesting pieces of legislation before our subcommittee is the capital gains tax cut which would allow us, if passed into law, to be more competitive and to involve and encourage savings and to create competition and to get jobs and praise the standard of living for all Americans. Unfortunately, the Treasury Department gives us figures that this is going to cost us $183 billion over a 10-year period. Sometimes I think when I go back to my other subcommittee that the reformation we are going through, those that have the benefits of the changes, get the benefits of the changes; but the SSI hearings I am holding, which involve the aged, the blind, the disabled, which involve the children—some born from irresponsible parents, they would be the losers in society and in this subcommittee.

But the issue before us, we don't have to discuss the cost because compared to the other costs, this is about 100 million a year lost revenue. But we can discuss the tax policy, and that is why Mr. Sutton is here, because as a kid the only thing I knew about people who looked like me was that they sang, they danced and shuffled, and they made people happy; and the only thing I knew about Africans is that if it were not for Tarzan and his significant other, why Africans would not be able to survive. Sadly, today, the portrayal I see on the news and documentary police force stories is that those creators of violence, of drug abuse, of irresponsible behavior, are really African-Americans.

I don't see students that work hard and achieve. I don't see men and women who try to make this a better America on television. That is why Ronald Reagan enacted and expanded a program that allows us, if we are not in the rooms to make the decisions as to what goes into the newspapers, if we are not there to make the decision as to what really goes on television, at least we should have a better-than-equal chance to be able to display all of America. I am a drum major for America; no country in the world would allow a poor guy like me from Lenox Avenue to even dream about sitting on this august subcommittee.

But, Mr. Sutton is, too. Mr. Sutton can trace his ancestry to slavery. He can say that he served as a fighter pilot in the U.S. Air Force and he was a lawyer for the poor, a civil rights leader. I might admit that the reason I care for him the most is that as he succeeded in politics, he made certain to look back and bring me along behind him—long behind him, but I was brought up, too.

He left as the chief executive elected official of the Borough of Manhattan—which some of us think is New York City, but it is not—and went into the broadcasting business to make us feel so proud that if we couldn't get on every station, at least we would be heard on his station. Owners, minority owners, Asian minority owners, all look to him as what can be done in America if given an opportunity.

So with you as the Chair and with witnesses like this, I feel pretty secure I can go back and try to protect those people who have nobody to testify for them.

Thank you, Madam Chairperson.

Chairman JOHNSON. Thank you very much, Mr. Rangel. It has been a pleasure to have you here for a few minutes. I appreciate your appearing to introduce your longtime friend and also to speak in support of affirmative action efforts. We both know what a difference they have made in the communications industry, without question. If you are not in the room, your perspective is not going to be heard by others.

So we do now see on programs like "Wall Street Week" as many black economists as white economists, as many women economists as men economists, so we are changing the world, and enlightened public policy is a part of that.

As I said in my opening remarks, this hearing is not aimed at the underlying policy of minority preference. It is aimed at an evaluation of the wise use of tax dollars. Part of our concern has been raised because unlike in the distressed sale policy of the FCC where the minority purchaser benefits because they get the asset at a lower cost, under this policy as it has evolved, the minority purchaser is not necessarily helped and may not necessarily have the voice and control the law requires.

I do think it is very interesting it has come out so clearly in this hearing that rather arbitrary legislation impeded the natural development of a sound policy in this area; and I am very pleased that there is going to be the opportunity for the FCC and the Treasury Department and this subcommittee to work together to make sure that abuse is not a problem, but that opportunity is the consequence.

So we look forward to your input as we move along. Thank you.

Mr. RANGEL. Let me join with you in that effort to make certain that we reach the objectives that the Congress wanted.

Thank you so much, Madam Chairman.

Chairman JOHNSON. First, we will have Bruce Fein.

STATEMENT OF BRUCE E. FEIN, ESQ., GREAT FALLS, VA., AND FORMER GENERAL COUNSEL, FEDERAL COMMUNICATIONS COMMISSION

Mr. FEIN. Thank you, Madam Chairman, and members of this subcommittee.

The racism fostered by the tax certificate policy of the Federal Communications Commission under section 1071 of the Internal Revenue Code is thoroughly pernicious and should be prohibited by Congress.

Chief Justice Harlan Fiske Stone lectured in *Hirabiyashi* v. *United States* that "Distinctions between citizens solely because of their ancestry are by their very nature odious to a free people whose institutions are founded upon the doctrine of equality."

On that score, the Chief Justice was echoing the stirring words of Justice John Harlan penned as a dissent in *Plessy* v. *Ferguson,* "In view of the Constitution, in the eye of the law, there is in this country no superior, dominant, ruling class of citizens." There is no

caste here. Our Constitution is colorblind and neither knows nor tolerates classes among citizens.

In respect to civil rights, all citizens are equal before the law. The humblest is the peer of the most powerful. The law regards man as man and takes no account of his surroundings or of his color when his civil rights, as guaranteed by the supreme law of the land, are involved.

Martin Luther King is heralded for his "I have a dream" speech in which he blessed the principle that "a person should be judged by the content of his character not by the color of his skin."

Congress itself has embraced the consensus of that rainbow coalition of civil rights deities in prohibiting any racial discrimination in the making of private contracts under 42 United States Code 1981. Senator Trumbell, sponsor of the bill, explained, "This bill applies to white men as well as black men. It declares that all persons in the United States shall be entitled to the same civil rights, the right to the fruit of their own labor, the right to make contracts, the right to buy and sell. The very object of the bill is to break down all discrimination between black men and white men."

The tax certificate policy of the Federal Communications Commission makes a mockery of equal justice and the constitutional imperative of color blindness. It rewards sellers of broadcast properties with lavish tax savings if the purchaser satisfies racial or ethnic criteria reminiscent of apartheid. In other words, the FCC bribes sellers to discriminate against buyers whose only sin is to have been born white. That bribery is an insult to the venerable standard of color blindness enshrined in both the Constitution and Federal statutes.

The justification for the racially discriminatory bribery is not help for the disadvantaged. If that were the case, buyers would be required to show disadvantage and there would be no color bar to eligibility. Neither is past racial discrimination a justification. If that were the case, the beneficiaries would be required to demonstrate they have been so victimized, and whites who have suffered from discrimination would not be excluded. Nor can the tax bribe be justified by enriching program diversity. Purchasers are not required to promise or implement programming changes; politically correct skin color, or ethnicity, simpliciter is sufficient to trigger the tax benefits of section 1071.

Within the human breast the craving for profit is colorblind. It thus wars with intuition and experience to assert that the race or ethnicity of a broadcaster is pivotal to programming content. Programming is driven by profitability, thus Hallmark Cards did not revamp the programming of stations purchased from Hispanic owners in markets with substantial percentages of Hispanic viewers.

The FCC itself has never been able to document any correlation between broadcast ownership and programming content. The reason for the failure is simple, there is no such thing as a "black," "Hispanic," "Asian" or other racially or ethnically identifiable viewpoint except perhaps in the eyes of racists.

Blacks in the United States, for instance, are emphatically not ideologically fungible. Associate Justice Clarence Thomas holds views sharply discrepant from Jesse Jackson and Barbara Jordan; the views of Gary Franks clash sharply with many in the Congres-

sional Black Caucus. Tom Sowell's views are not the echoes of Benjamin Hooks or Louis Farrakhan, and black ideological pluralism is no novelty. Booker T. Washington and W.E.B. Dubois were ideological antagonists for long years around the turn of the last century.

Ward Connerly, a black California businessman on the Board of Regents of the University of California, recently voiced objection to affirmative action programs as inequitable and unfair to certain people. He also expressed chagrin at the reflex encouraged by affirmative action to be viewed first and foremost as a member of a racial group rather than as an individual. Do Mr. Connerly's opinions reflect a black viewpoint in the mind of the FCC? To assert existence of such a viewpoint is to portray racial stereotyping that is more to be denounced than imitated.

Chairman JOHNSON. Your time has expired—I am sorry—because we have so many panelists.

Mr. FEIN. I think this is important, if I could say, it was Justice Clarence Thomas who recently voiced, I think, disgruntlement with the racial stereotyping encouraged by the idea that blacks think alike and therefore they can either be gerrymandered or treated as alike for diversity purposes.

I have gone on in my testimony to suggest that in my judgment, it is dubious under one Supreme Court decision, the *Metro Broadcasting* case, that the current composition of the Court would uphold the section 1071 racial preference program as constitutionally sufficient. There is, I think, a clear pronouncement by the U.S. Supreme Court that simply to increase representation of minorities in any profession or occupation for the sole purpose of increasing representation is not constitutionally satisfactory.

Let me conclude very quickly here.

The fact that tax certificate policy elicits hallelujahs within the business community is not surprising. It is a coveted tax avoidance device, and when money is at stake, Constitution or moral principles receive short shrift from the typical businessman. I do not recall that businessowners played heroic roles in the ugly days of Jim Crow, the Freedom Riders, and Bull Conner's dogs and horses.

Putting aside its constitutional deficiencies and entrenchment of racism, section 1071 seems a wildly profligate tool for advancing policies of the FCC. There is no limit on the amount of tax savings for racially favored transactions.

Chairman JOHNSON. I really do have to ask you to conclude, Mr. Fein.

Mr. FEIN. Yes.

Chairman JOHNSON. Your entire testimony will be placed in the record and it will be available for review by the members.

Mr. FEIN. I understand.

I think the reason why this kind of approach to entrusting to agencies the authority to give tax certificates is exceptionally unwarranted and unwise is because the Commission has not been asked, like other agencies, to recover the tax revenues lost through their own administration of the program. That is why I think it has—I think, extravagantly expanded the program beyond broadcast into cable and PCS without, in my judgment, any clear directive from Congress.

In sum, in my judgment, section 1071 is twice cursed, fosters racial polarization and stereotyping, and promotes fiscal profligacy in an era of austerity.

[The prepared statement follows:]

STATEMENT OF BRUCE FEIN
FORMER GENERAL COUNSEL OF THE FEDERAL COMMUNICATIONS COMMISSION AND ASSOCIATE DEPUTY ATTORNEY GENERAL

Ms. Chairperson and Members of the Subcommittee:

The racism fostered by the tax certificate policy of the Federal Communications Commission under section 1071 of the Internal Revenue Code is thoroughly pernicious and should be prohibited by Congress. Chief Justice Harlan Fiske Stone lectured in Hirabiyashi v. United States (1943) that: "Distinctions between citizens solely because of their ancestry are by their very nature odious to a free people whose institutions are founded upon the doctrine of equality." On that score, the Chief Justice was echoing the stirring words of Justice John Harlan penned as a dissent in Plessy v. Ferguson (1896): "[I]n view of the Constitution, in the eye of the law, there is in this country no superior, dominant, ruling class of citizens. There is no cast here. Our Constitution is color-blind, and neither knows nor tolerates classes among citizens. In respect of civil rights, all citizens are equal before the law. The humblest is the peer of the most poweful. The law regards man as man, and takes no account of his surroundings or of his color when his civil rights as guaranteed by the supreme law of the land are involved." And Martin Luther King is heralded for his "I have a dream" speech in which he blessed the principle that a person should be judged by the content of his character not by the color of his skin."

Congress has embraced the consensus of that rainbow coaltion of civil rights deities in prohibiting any racial discrimination

in the making of private contracts under 42 U.S.Code 1981. Senator Trumbell explained: "[T]his bill applies to white men as well as black men. It declares that all persons in the United States shall be entitled to the same civil rights, the right to the fruit of their own labor, the right to make contracts, the right to buy and sell...[T]he very object of the bill is to break down all discrimination between black men and white men."

The tax certificate policy of the Federal Communications Commission makes a mockery of equal justice and the constitutional imperative of color-blindness. It rewards sellers of broadcast properties with lavish tax savings if the purchaser satisfies racial or ethnic criteria reminiscent of apartheit. In other words, the F.C.C. bribes sellers to discriminate against buyers whose only sin is to have been born white. That bribery is an insult to the venerable standard of color-blindness enshrined in the Constitution and section 1981.

The justification for the racially discriminatory bribery is not help for the disadvantaged. If that were the case, buyers would be required to show disadvantage and there would be no color bar to eligibility. Neither is past racial discrimination the justification. If that were the case, the beneficiaries would be required to demonstrate that they have been so victimized, and whites who have suffered from discrimination would not be excluded. Nor can the tax bribe be justified by enriching programming diversity. Purchasers are not required to promise or implement programming changes; politically correct skin color or ethnicity,

simpliciter, is sufficient to trigger the tax benefits of section 1071.

Within the human breast, the craving for profit is color-blind. It thus wars both with intuition and experience to assert that the race or ethnicity of a broadcast owner is pivotal to programming content. Programming is driven by profitability; thus, Hallmark Cards did not revamp the programming of stations purchased from Hispanic owners in markets with substantial percentages of Hispanic viewers. The F.C.C. itself has never been able to document any correlation between broadcast ownership and programming content. The reason for the failure is simple: there is no such thing as a "black," "Hispanic," "Asian," or other racially or ethnically identifiable viewpoint, except perhaps in the eyes of racists. Blacks in the United States, for instance, are emphatically not ideologically fungible. Associate Justice Clarence Thomas holds views sharply discrepant from those of Jesse Jackson and Barbara Jordan. The views of Congressman Gary Franks clash with many in the Congressional Black Caucus. Tom Sowell's views are not echoes of Benjamin Hooks or Louis Farrakhan. And black ideological pluralism is no novelty. Booker T. Washington and W.E.B. Dubois were ideological antagonists for long years around the turn of the last century.

Ward Connerly, a black California businessman on the Board of Regents of the University of California, recently voiced objection to affirmative action programs as inequitable and unfair to certain people. He also expressed chagrin at the reflex encouraged by

affirmative action to be viewed first and foremost as a member of a racial group, rather than as an individual. Do Mr. Connerly's opinions reflect a "black" viewpoint in the mind of the F.C.C.?

To assert the existence of such a viewpoint is to betray racial stereotyping that is more to be denounced than imitated. To paraphrase the eloquence of Justice Clarence Thomas in Holder v. Hall (1994), the programming assumptions behind the F.C.C.'s section 1071 tax certificate policy "should be repugnant to any nation that strives for the ideal of a color-blind Constitution." They presume all blacks think alike. There may be better ways to inflame race relations, but if there are, they do not readily come to mind.

It is arguable that the tax certificate policy would pass constitutional muster under the Supreme Court's narrow 5-4 precedent in Metro Broadcasting v. F.C.C. (1990). But three members of the Metro majority have since departed the High Court, and I believe that the precedent is destined for overruling. In any event, a racist policy that passes constitutional scrutiny is still repugnant and should not be tolerated. That is a lesson the nation learned from its odious treatment of loyal citizens of Japanese ancestry during World War II which received the constitutional blessing of the Supreme Court. Congress later made partial amends for the racism in the Civil Liberties Act of 1988 which granted $20,000 to the victims or their families.

It seems clear under the Supreme Court's ruling in Regents of University of California v. Bakke (1978) that the F.C.C.'s tax

ceertificate policy cannot be constitutionally justified by a desire to increase minority ownership of broadcast properties, without more. As Justice Lewis Powell elaborated in Bakke, to seek some specified percentage of a particular group in a student body, occupation or otherwise "merely because of its race or ethnic origin...must be rejectd...as facially invalid. Preferring members of any one group for no reason other than race or ethnic origin is discrimination for its own sake. This the Constitution forbids."

The fact that the tax certificate policy elicits hallelujahs within the business community is unsurprising. It is a coveted tax avoidance device, and when money is at stake constitutional or moral principles receive short-shrift from the typical businessman. I do not recall that business owners played heroic roles during the days of Jim Crow, the Freedom Riders and Bull Conner's dogs and hoses.

Finally, putting aside its constitutional deficiences and entrenchmant of racism, section 1071 seems a wildly profligate tool for advancing policies of the F.C.C. There is no limit on the amount of tax savings for a racially favored transaction; indeed, neither the F.C.C. nor the Department of Treasury makes any effort to calculate the tax loss of a section 1071 sale. Thus, the section probably confers monetary benefits vastly exceeding the amount needed to catalyze a sale to a minority-controlled investment group. The gold-plated tax certificate of Viacom is exemplary.

The prodigality of the F.C.C. under section 1071 is

predictable. The Commission is not tasked to discover new sources of revenue to offset section 1071 tax losses, unlike Congress. When the cost to the F.C.C. of granting tax certificates is zero, a healthy incentive for frugality is lost. That seems at least a partial explanation of the Commission's extension of section 1071 to cable properties in the face of statutory language confining its scope to "radio broadcasting stations." The section is an extravagance that the nation cannot afford when cries for a balanced federal budget is the voice of the people.

In sum, section 1071 is twice-cursed: it fosters racial polarization and stereotyping; and, it promotes fiscal profligacy.

Chairman JOHNSON. Thank you.
Next is Mr. Foster.

STATEMENT OF J.D. FOSTER, PH.D., EXECUTIVE DIRECTOR AND CHIEF ECONOMIST, TAX FOUNDATION

Mr. FOSTER. Thank you, Madam Chairman. I am J.D. Foster; I am the executive director and chief economist of the Tax Foundation, a nonprofit, nonpartisan research and education organization.

I am going to restrict my remarks to the economic aspects of this issue and leave the debate about social and communication policies to others more qualified. I am not going to try and argue for or against the program or any changes to the program. I intend simply to present the underlying economics as best I have been able to determine them.

The situation is this, as I understand it: We have a transaction, specifically, the sale of a broadcast facility; and as the result of the sale, the FCC has authority to give tax relief intended to benefit the seller or buyer. In this case, the form of the relief is not particularly relevant; the question is really whether the tax relief can be justified on economic grounds.

A fundamental tenet of good tax policy is that taxation should be neutral and should not micromanage the economy. Tax neutrality is important because when taxes distort how resources are employed, the result is almost always lower wages, fewer jobs, and lost output. The Federal tax system is replete with nonneutralities, and some impose a very heavy tax burden on the economy, such as the tax burden on savings. However, others are much narrower, such as the FCC tax certificate program, the subject of this hearing.

These certificates allow the taxpayer to reduce or defer capital gains tax liability, in general, and in most cases the taxation of capital gains is highly distortionary. There is a direct tax on capital, reducing the incentive to save and invest, and broad-based reductions in the base improve the neutrality of the Tax Code. Targeted reductions in the capital gains improve neutrality of the system by reducing distortion against savings and investment. On the other hand, targeted reductions distort allocation of capital by shifting capital to tax-favored uses.

In general, such a targeted tax benefit is only warranted on economic grounds if it compensates for particular shortcomings in the marketplace, called an externality. Increasing minority ownership of broadcast facilities is a social policy and not a response to an economic externality. Therefore, the FCC tax certificate program is an instance of micromanagement of the economy which cannot be supported on the basis of the need to offset a peculiar economic condition.

Another possible economic justification has to do with private property rights. I think this probably goes back to the history of the original FCC program. To the extent FCC policy results in the involuntary sale of a broadcast facility, even if at fair market price, some form of compensation is appropriate. Thus, whenever the FCC requires the sale of a facility and the transfer is purely voluntary, then the tax benefits conferred by the tax certificate could be considered an appropriate form of compensation.

The problem, however, is that the tax benefit is only partly enjoyed by the seller of the asset. In the marketplace, since buyer and seller are both aware of the possible tax benefit, the value is considered by both parties in establishing a sales price.

For example, suppose the value of a facility in the absence of the tax certificate was $50 million and the value of the certificate is $5 million. The final sales price could fall anywhere between $45 and $50 million, depending on which side gets most of the tax benefit. The share of the benefit enjoyed by each party will vary by case, but it is almost certain that in every case there will, in fact, be a sharing. Therefore, the just compensation argument supports the program only to the extent the entire benefit of the tax is conferred on the sellers of the facilities since it is their loss of control of the asset which justifies the benefit.

Therefore, it appears that this program is either largely or entirely a tax subsidy to the transfer of an asset—in this case, the broadcast facility—and therefore, the program is equivalent to any other designed to benefit a special interest such as our financial markets or merchant shipping subsidy, except the beneficiary group is determined by race or gender rather than industrial classification.

Many Federal programs ultimately have a significant rent seeking quality, that being the expression for actions of an individual or group that seeks a special benefit from the government. Whether a particular group should be granted a special benefit is again a social policy and not an economic policy. Common sense, however, provides a simple test of the extent to which a program has a significant rent-bestowing character: who favors the program and do they receive a financial benefit from the program? In the case of the FCC tax certificate, this hearing and the testimony given offers the clearest evidence of who may be rent seeking.

In conclusion, the program to expand minority ownership of broadcast facilities reflects three policy decisions, the first of which is to increase the number of minority-owned broadcast facilities and, as such, is almost entirely a social policy.

The second is to compensate the former owners of the facility for the loss of control of their property when the sale is made involuntarily. This compensation, however, only arises to the extent the purchase price of the facility is not reduced to reflect a sharing of the tax benefit.

The third policy reflected is to subsidize the purchase of broadcast facilities through shared tax benefits granted by the certificates. There is no economic justification for such a subsidy program, which, like all attempts to subsidize or penalize economic activities, distorts the allocation of precious resources.

Therefore, the subsidy, too, must be regarded purely as a social policy decision.

Thus, I conclude that the policy is a social policy which carries a cost in the form of a tax distortion; and the political question and not the economic question is whether the price is worth what you are getting for the policy.

Chairman JOHNSON. I think you phrased it very well, Mr. Foster.

[The prepared statement follows:]

Statement of

J.D. Foster, Ph.D.
Executive Director and Chief Economist

Tax Foundation

on

The Economics of Section 1071: The FCC Tax Certificate Program

January 27, 1995

Madam Chairwoman and Members of the Committee, my name is J.D. Foster and I am the Executive Director and Chief Economist of the Tax Foundation. The Tax Foundation is a non-profit, non-partisan research and public education organization that has been monitoring fiscal policy at all levels of government since 1937. I would like to emphasize to the Committee that the Tax Foundation is not a "grass-roots" organization, a trade association, or a lobbying organization. We do not take positions on specific legislation or legislative proposals. Our goal is to explain as precisely and clearly as we can the current state of fiscal policy and the consequences of particular legislation in the light of specific tax principles so that you, the policy makers, may make informed decisions.

I appreciate the opportunity to appear before you today to discuss Section 1071 of the Internal Revenue Code which allows the Federal Communications Commission (FCC) to grant tax relief with respect to the sales of radio, television, and other properties under certain circumstances. This demonstrates, I think, that even at a time when such fiscally colossal issues like a balanced budget amendment and the "Contract with America" dominate our attention, there remain many important issues that should not be neglected, even though they may never appear above the fold on the morning paper. I commend the Committee for taking the time to address this issue.

Madam Chairwoman, I will restrict my remarks to the economic aspects of this issue and leave the debate about the social and communications policy to others more familiar with those aspects. It is not my purpose today to argue in favor of or against the program, or for or against any changes in the program, but rather to present its underlying economics as best as I have been able to determine them.

The FCC Tax Certificate Program

Under Section 1071, the FCC has the authority to grant a tax certificate to the former owners of certain broadcast facilities when the sale or exchange of those facilities is certified by the FCC "to be necessary or appropriate to effectuate a change in a policy of, or the adoption of a new policy by, the Commission with respect to the ownership and control of radio broadcasting stations..." Since 1978, the FCC has used this provision as a tool for its announced policy of promoting minority ownership of broadcast facilities. The tax certificate gives the taxpayer the right to elect to treat the sale or exchange as an involuntary conversion under Code Section 1033. The tax benefit generally is to allow the former owner to defer the realization of capital gain on the sale or exchange of the asset if the proceeds from the sale are used to purchase similar property. To the extent the taxpayer does not utilize the involuntary conversion rules, the capital gain resulting from the sale or exchange of the asset shall nevertheless not be recognized, if the taxpayer so elects, because the taxpayer may reduce the basis for determining gain or loss on sale or exchange of property if the property would qualify for depreciation under I.R.C. Section 167.

Tax Neutrality

Madam Chairwoman, when it was founded some 58 years ago the Tax Foundation established six Principles of Taxation to guide its analysis. One of these principles was that the tax code should not be used to micro-manage the economy. That is, the tax code should be as neutral as possible with respect to economic decision making. Tax neutrality is important because when taxes distort how resources are employed, the net result is almost always a lowering of wages, fewer jobs, and lost output. Thus, a non-neutral tax removes resources from the private sector in two ways: through the collection of the tax itself and through the income lost because of the mis-allocation of resources–what is called the deadweight loss.

Border tariffs offer a classic example of the deadweight loss from taxation. Tariffs are external taxes and, as such, distort the prices of foreign goods and services relative to domestic goods and services, thereby distorting the allocation of domestic resources like capital and labor. The history of modern trade policy is a nearly continuous effort to reduce tariffs because to do so results in an expansion of trade and an expansion of national output through the more productive use of resources.

Another example of a non-neutral tax and its deadweight loss involves the taxation of capital. Some states, for example, impose a specific tax on plant and equipment located within the state. These taxes on real capital reduce the amount of capital employed. Consequently, the workers in those states have less capital with which to work. We know that workers are generally paid more as the tools they work with improve (a fisherman generally will catch more fish with a net than with a single line, for example), so one consequence of this tax is that wages in these states are depressed relative to what they would otherwise be.

The federal tax system is replete with non-neutralities, almost all of which result in less output, fewer jobs, and lower wages. Some of these, such as the heavy tax burden on saving, are very broad in application and carry steep price tags. Others are much narrower, such as the FCC tax certificates which are the subject of this hearing.

It is important to note that there are occasions when the tax code is non-neutral by design. In many instances, the underlying policy is an attempt to address an economic externality through the tax code. An externality arises when the individuals involved in an activity are unable to enjoy all the economic benefits or do not bear all the economic costs of an activity. An example of the former would be a software manufacturer whose products are pirated; an example of the latter would be a restaurant which has a band that plays music so loud that it drives away customers from the restaurant next door.

The Research and Experimentation Tax Credit exemplifies a tax provision enacted in recognition of a positive externality. Even with patent and copyright protection, many of the economic benefits that follow from R & E activity cannot be captured through product sales or pricing by the company doing the work. As a result, a lower level of R & E activity is performed than would be socially desirable. This is an externality which the tax credit seeks to offset.

There are also many examples of taxes imposed to address negative externalities. One such is the gasoline excise which attempts to force the users of gasoline to pay for the amount of the resource they consume through the product's price, but also for the economic cost of the pollution that is thereby generated through the gasoline excise.

To summarize, through its non-neutralities the current tax code severely distorts the allocation of national resources, thereby reducing output, wages, and employment. While most of the non-neutral provisions in the tax code are the by-products of other policy choices (a desire for a progressive tax system, the choice of income as a tax basis, and so forth), some are deliberate attempts to use the tax code to capture economic externalities. Good tax policy should seek to eliminate the former and to target the latter most carefully.

The Taxation of Capital Gains

In general and in most cases, the taxation of capital gains is highly distortionary. Except in instances in which the capital gain arises directly as a result of reinvesting income, such as corporate retained earnings, the capital gains tax is a levy on capital and not on the income accruing to capital. As a direct tax on capital, the capital gains tax reduces the incentives to save and invest. Therefore, broad-based reductions in the tax improve the neutrality of the tax code.

The capital gains tax can be reduced in three ways: by reducing the tax rate which is applied to taxable gains, by reducing the amount of a taxable gain that is subject to tax (either through a percentage exclusion, by indexing the basis for inflation, or by a simple increase in the basis), or by allowing the taxpayer to defer the recognition of the capital gain. Deferral arises most notably when home owners sell one home and buy another, though it also arises in private saving arrangements such as Individual Retirement Accounts. The deferral of tax is one of the tax benefits conferred on qualifying sales of broadcast stations. A step-up in basis, which occurs in the tax code most notably in levying the estate tax, is a second tax benefit recipients of FCC tax certificates enjoy.

Targeted reductions in the capital gains tax on the one hand improve the neutrality of the tax system by reducing the distortion against saving and investing. On the other hand, however, targeted reductions in the capital gains tax can distort the allocation of capital by shifting capital to tax-favored uses. In general, such a targeted tax benefit would generally only be warranted on purely economic grounds if it were used to offset some externality as discussed above.

To the extent the FCC tax certificate program is attempts to capture an externality, and in this regard is similar to attempts to address other externalities such as polluting emissions, it must be recognized that the program seeks to address a social condition and not an economic externality, in which case economic arguments do not apply. Increasing minority ownership of broadcast facilities is social policy and not a response to an economic externality. Lacking any externality aspects, therefore, the FCC tax certificate program represents an instance of micro-management of the economy which cannot be supported on the basis of the need to offset an anomalous economic condition.

Property Rights and the Certificate Program

Property rights are the very backbone of our economic system. Much of our judicial system exists to protect private property from confiscation or loss of value through the actions of either individuals or governmental entities. Whenever an individual believes his or her private property can be taken without due process and just compensation, their economic energy and vitality diminishes.

The FCC tax certificate program is intended, in part, to diversify ownership of broadcast facilities to encourage greater minority control. To the extent this government policy goal results in the involuntary sale by private individuals of broadcast facilities to any other party, even if at a fair-market price, some form of compensation is appropriate. Thus, in any case where the FCC requires that a private individual or group sell a broadcast facility, for whatever reason, to another individual or group, and the transfer is truly involuntary, then the tax benefits conferred by the FCC tax certificate program could be considered an appropriate form of compensation.

Sharing The Benefit

The tax benefits are conferred on the former owners of broadcast facilities by the FCC tax certificate in the sense that the tax benefits are theirs to claim. In the marketplace, since both the buyer and the seller are aware of the possible tax benefit, the value of the benefit will be considered by both parties in establishing the sales price. For example, suppose the value of a broadcast facility in the absence of capital gains tax deferral is $50 million, and that the value of the deferral to the seller is deemed to be $5 million. The final

sales price could fall, therefore, anywhere between $45 million, in which case the buyer gets the full benefit of the deferral, or $50 million in which case the seller gets the full benefit. The share of the benefit enjoyed by the seller and the buyer will vary case-by-case, but, it is likely that in nearly every case both the buyer and the seller will enjoy some portion of the tax deferral benefit.

Therefore, the argument that the FCC tax certificate is just compensation for the involuntary nature of the sale or exchange, to the extent it was in fact involuntary, supports the program only to the extent the entire benefit of the tax is conferred on the sellers of the broadcast facilities since it is their loss of the control of the asset which has given rise to the need for the benefit. However, since in most markets it is not possible to guarantee the entire amount of the tax benefit will be retained by the former owner, the tax benefit loses its character of compensation for involuntary conversion and becomes a simple subsidy to the new owners.

Rent-Seeking and the FCC Tax Certificate

The foregoing discussion leads to the conclusion that the FCC tax certificate program can only be justified on economic grounds in those cases in which the sale of the broadcast facility is truly involuntary and in which the entire tax benefit is enjoyed by the seller of the facility. In the absence of any other economic rationale, the tax certificate program becomes the equivalent of any number of subsidy programs designed to benefit some special interest. In other words, except under the narrow conditions described above (involuntary conversion and seller beneficiary), as an economic matter the FCC tax certificate program becomes indistinguishable from farm subsidies or merchant shipping subsidies, except that the beneficiary group is determined by racial rather than by industrial classification.

There are many federal programs which ultimately have a significant rent-seeking quality. (Rent seeking is the economic expression for the actions of any individual or group that seeks special benefits from a governmental entity). Strictly speaking, whether a particular group should be granted special benefits a matter of social policy, rather than economic policy, and to this extent outside the purview of economic analysis.

Common sense provides a simple test, however, of the extent to which a program has a significant rent-bestowing character. This test is unnecessary in most cases since, like farm subsidies, it is easy enough to determine who the rent seekers are, namely the farmers. In the case of the FCC tax certificate program, however, the existence and definition of the rent-seekers is less clear and so the test is more helpful.

The simple rent-seeking test is this: Who favors the program and do they receive a financial benefit from the program? In the case of the FCC tax certificates, this hearing and the testimony given may offer the clearest evidence of who may be rent-seeking, a matter I will leave to the Committee to decide.

Conclusion

The FCC tax certificate program to expand minority ownership of broadcast facilities reflects three policy decisions. The first is to increase the number of minority owned broadcast facilities and, as such, is almost entirely a social policy. The second policy is to compensate the former owners of the facility for the loss of control of their property when the sale was made involuntarily. This compensation arises, however, only to the extent that the purchase price of the facility is not reduced to reflect a sharing of the tax benefit between purchaser and seller.

The third policy reflected by the program is to subsidize the purchase of broadcast facilities through the shared tax benefits granted by the tax certificates. There is no economic justification for such a subsidy program which, like all attempts to subsidize or penalize particular economic activities, distorts the allocation of precious resources. Therefore, the subsidy, too, must be regarded purely as a social policy decision.

Chairman JOHNSON. Mr. Gattuso, I would appreciate if you could focus your remarks very tightly so that we could dismiss this panel before we have to leave to vote in about 10 minutes.

STATEMENT OF JAMES GATTUSO, VICE PRESIDENT, POLICY DEVELOPMENT, CITIZENS FOR A SOUND ECONOMY

Mr. GATTUSO. I will do my best.

Thank you for inviting me here today. I am James Gattuso, vice president, Policy Development at Citizens for a Sound Economy, a 250,000-member nonpartisan, nonprofit consumer advocacy group that promotes market-based solutions to public policy problems.

I want to first summarize the points I want to make.

I believe the FCC's tax certificate program is a failed program. It has benefited the rich and well-connected, not the disadvantaged. It has failed to increase diversity in programming. It raises some troubling questions regarding the government's role in matters of speech.

First, the beneficiaries of this program are not people whom one usually thinks of as being in need. Rather, the individuals who benefit from the current FCC program are those who already have substantial resources or connections. Simply put, the poor do not buy communications companies. Those who have been beneficiaries of this program include not only large corporations such as Viacom, but also include individuals such as Bill Cosby, outfielder Dave Winfield, and even talk show host Oprah Winfrey. These are not people trapped by economic disadvantage or their ethnic heritage. They are not people who require compensation for past wrongs. They are not people the American taxpayers should be asked to help. Yet these are the types of people who have benefited the most.

There is also little evidence this program has increased diversity in programming. The FCC's policy is based on the premise that change in ownership will lead to a change of programming. The evidence for such a connection is tenuous at best. Common sense tells us the demands of consumers, not the owner, is the primary determinant of programming.

Madam Chairman, communication executives are business people; regardless of color, race, or ethnicity, they provide programming that generates the largest profits. Conversely, white-owned firms can and do offer diverse programming when that is what consumers demand.

I would like to mention one well-known example of this, the growing Fox Network. This network owes much of its success to its ability to attract minority audiences. Several of its shows now rank in the top ranks of black viewership, for example. Fox's diverse programming is not due to any government program, but instead to a recognition of the economic benefits of providing what consumers want to see. This issue is discussed in more detail in my written statement.

I would like to point out, however, that more information would be available on this point but for Congress itself. Several years ago when the FCC decided to research this matter, Congress forbade it from acquiring the information. I understand it has continued that prohibition every year thereafter.

The FCC policy also has some serious First Amendment implications. How did the FCC determine that the term "minorities" should be limited to blacks, Hispanics, American Indians, Alaska Natives, Pacific Islanders? The lack of Polish polka radio stations, Pakistani sitcoms, and Australian documentaries is quite apparent in the United States. Yet these groups don't meet the minority standards set by the FCC.

I don't mean to trivialize this issue. I just want to point out that in making these decisions, the FCC is forced to make decisions as to the relative merits of different types of speech.

The FCC is saying certain types of speech are favored and other types are not favored. Such a role for the government is troubling even if meant to advance a good cause.

Ending this program doesn't mean the government should not work to increase program diversity and opportunity for minorities in telecommunications. I would suggest that there are several steps the Congress could take to lower existing barriers to minority ownership and diversity in communications. One such step would be a tax reduction, across-the-board tax reduction, perhaps in the area of capital gains which would help spur investment in small and medium size companies, a category that includes most minority-owned firms.

Congress should also look at communications regulations which hinder the growth of programming diversity. A good place to start, although it is outside the jurisdiction of this subcommittee, would be the Cable Act of 1992. The reduction in industry investment caused by that Act threatens to curb the growth of the small, specialized cable channels which have helped increase program diversity so much in recent years.

Madam Chairman, the results of last November's elections were clear: The American people want an end to special interest politics as usual. Repeal of the FCC tax certificate program would send a signal that Congress has heard that message. Created with good intentions, this program serves as a welfare program for some of the wealthiest members of society, while utterly failing to help disadvantaged minorities.

Congress should put an end to it.

Thank you for the opportunity to speak to you, and I will be open to any questions you may have.

[The prepared statement follows:]

STATEMENT OF JAMES GATTUSO
VICE PRESIDENT FOR POLICY DEVELOPMENT
CITIZENS FOR A SOUND ECONOMY

Good morning. Madame Chairman and Members of the Subcommittee on Oversight. My name is James Gattuso, and I am Vice President for Policy Development at Citizens for a Sound Economy, a 250,000 member non-partisan, non-profit consumer advocacy group that promotes market-based solutions to public policy problems. Thank you for inviting me here today to discuss the Federal Communication Commission's (FCC) tax certificate program. As you know, this provision allows broadcasting and cable firms to defer payment of capital gains taxes when their property is sold to a minority-owned entity. This deferral can be made permanent if profits from the sale are reinvested in "qualified" media properties within two years and if the minority owner maintains controlling power for a least one year .

This program was established seventeen years ago to boost minority ownership of broadcasting and communication businesses. The goal was to increase broadcast and cable "diversity," and increase the amount of broadcast and cable programming serving the needs and interests of minorities.

The program, however, has failed. It has benefitted the rich and well-connected, not the disadvantaged; it has failed to increase diversity in programming; and it raises serious questions regarding free speech.

FROM RICHES TO RICHES

The tax certificate program has helped bring in some minority owners in particular cases. However, the beneficiaries are not people that one usually thinks of as being in need. Rather, the individuals that benefit from the current FCC program are -- almost by definition -- those who already have substantial resources. Simply put, the poor do not buy communications companies. A potential buyer must be financially well-endowed and well-supported just to be considered a serious purchaser. This financial position places most potential buyers in the high income brackets of society.

Thus, in addition to large corporations such as Viacom, the beneficiaries of this program have included the likes of comedian Bill Cosby, outfielder Dave Winfield, and talk show host Oprah Winfrey. These are not people trapped by economic disadvantages or their ethnic heritage. These are not people who require compensation for past wrongs. These are not people whom the American taxpayer

should be asked to help. Yet these are the type of people who benefit the most.

One extreme example of the problems of this program was the 1987 sale of WTVT in Tampa, Florida. The FCC granted WTVT owner Gaylord Broadcasting Co., a $116 million tax break on the sale. Gaylord had sold WTVT to communications investor George Gillet, Jr. and to black lawyer Clarence V. McKee, a former FCC staffer who helped write the tax certificate rules and who had no television operations experience. McKee maintained controlling power of WTVT for one year, after which he sold his share to Gillet for $1 million. The end result was a $116 capital gains deferment for Gaylord Broadcasting Co., large profits for McKee and other investors, but no increase in minority ownership. Gillet was also involved in a similar deal with Alaskan Eskimos during the sale of a Nashville TV station in winter of 1988 and 1989.

This is not to say that these men and women do not have the right to own and sell communications companies. What is wrong is federal support for their investments.

BUT WHAT'S ON T.V.?

One of the goals behind the FCC's incentive package was to increase programming "diversity". A change is ownership would, the FCC believed, lead to changes in programming. The evidence for such a connection is tenuous at best. To the contrary, common sense tells us that the demands of consumers, not the race of the owner, is the primary determinant of programming decisions. If there were a market for Eskimo music or shows about Pacific Islanders, then these programs would be offered.

This is the essential idea behind the concept of supply and demand. Producers will supply what consumers demand. Communication executives are businesspeople, regardless of color, race, or ethnicity. They will provide programming that draws the largest audience and generates the largest profits. When an Hispanic man takes over a previously white owned company, he will not automatically start showing more Hispanic soap operas. At least, he won't if that's not what his audience wants.

Conversely, white-owned firms can and do offer diverse programming when that is what consumers demand. For example, the growing Fox network owes much of its success to its ability to attract minority audiences, with several of its shows in the top ranks of black viewership. Fox's diverse programming is not due to any government program, but instead stems from a recognition of the economic benefits of providing what consumers want to see.

There is little academic evidence showing a correlation between an owner's ethnicity and programming. Speaking on the relationship between minority-owned communication companies and minority programming, Christopher H. Sterling of George Washington University reports that "what research has been done so far comes up showing no significant difference[s]."

It is noteworthy that more information would be available on this point but for Congress itself. Several years ago, when the FCC decided to research this

matter Congress forbade it from acquiring the information, and has continued the prohibition every year thereafter.

WHAT IS GOOD SPEECH?

The FCC policy also has some serious First Amendment implications. How did the FCC determine that "minorities" should be limited to "Blacks, Hispanics, American Indians, Alaska Natives, Asians, and Pacific Islanders?" The lack of Polish polka radio stations, Pakistani sit-coms, and Australian documentaries is apparent in the United States. Yet these ethnic and racial groups do not meet the "minority" standards set by the FCC. Are the diversity needs of these sub-groups less important than those certified by the FCC?

In making these decisions, the FCC is forced to make decisions as to the relative merits of different types of speech. It is saying that certain types of speech are favored, and that other types are not favored. Such a role for the government is troubling, even if meant to advance a "good cause".

BETTER SOLUTIONS

Ending the FCC tax certificate program does not mean that the government should not work to increase program diversity and opportunities for minorities in telecommunications. There are, in fact, a number of steps which Congress could take which would be both fairer and more effective than this program. An across-the-board tax reduction, especially a reduction in capital gains taxes, would help spur investment in small- and medium-sized companies, a category which includes most minority-owned firms.

Congress should also look at communications regulations which hinder the growth of programming diversity. A good place to start -- although it is outside the jurisdiction of this committee -- would be the Cable Act of 1992. The reduction in industry investment caused by this act threatens to curb the growth of small, specialized cable channels, which have helped increase program diversity tremendously in recent years.

CONCLUSION

The results of last November's elections were quite clear: the American people want an end to special interest "politics as usual." Repeal of the FCC's tax certificate program would send a signal that Congress has heard that message. Created with good intentions, this program has served as a welfare program for some of the wealthiest members of society, while utterly failing to help disadvantaged minorities. Congress should put an end to it. Thank you for allowing me this opportunity to speak, and I am open to any questions you may have.

Chairman JOHNSON. Thank you. We appreciate it. Very good remarks.

Mr. Wilde.

STATEMENT OF BRUCE R. WILDE, ESQ., ROGERS & WELLS, NEW YORK, N.Y.

Mr. WILDE. Thank you, Madam Chair, and members of the subcommittee. I make my living as a corporate and securities lawyer at a Wall Street law firm. I want to state I am not here on behalf of my employer or any client. I am here stating personal views.

Several years ago when I was in law school, I became interested in the policies the FCC had adopted to promote minority ownership of broadcasting facilities. I studied those policies, including the tax certificate program under section 1071.

I came to the conclusion then that the existing policies, especially the certificate program, are not very well designed and are vulnerable to abuse. I wrote an article in the University of Pennsylvania Law Review criticizing the tax certificate program, which was published in 1990. I am submitting a copy of that piece for the record and for the subcommittee's use. I would like to summarize the points I made back in 1990, which I think are still valid criticisms today, and most, indeed, have already been referred to by some other witnesses.

[The University of Pennsylvania Law Review article is retained in committee files due to its size.]

Mr. WILDE. I believe that the tax certificate program is constitutional today by virtue of the Metro Broadcasting decision (497 U.S. 547 (1990)), but I think it should be understood that its constitutionality is dependent upon the continued blanket endorsement that the Congress provided through the appropriations rider. Were that to be withdrawn, I think that a different level of scrutiny would apply to the program, and I doubt that it would survive the scrutiny which would then be applied.

Tax certificates are, as has been mentioned earlier, an uncontrolled, open-ended drain on tax revenues. It is like an entitlement program. We really don't know what it is costing us or what it might cost us in the future. Also, the benefit that the seller gets is determined by the amount of capital gain realized; the benefit may be far more than would be necessary to encourage the sale to the minority enterprise, which is what we want, and that, of course, is a waste.

The best answer, I think, would be to replace the program with a direct spending program such as loan subsidies to help qualified minority entrepreneurs get into the broadcasting business. That way, Congress could determine how much to spend on the program and the FCC could direct the aid where it would do the most good in terms of increasing minority ownership.

If the program is to be kept within the tax system, there are several improvements that should be made. The amount of deferred capital gains should be limited to no more than 30 percent of the selling price of the broadcast property. I think that would be ample incentive.

Another problem is that the seller can get a tax certificate without showing that the minority persons will direct the day-to-day op-

eration of the station after the sale, or that viewpoint diversity actually will be increased. If we want minority viewpoints on the air, we would have to require that the buyer have minority management, as well as ownership, as well as some kind of showing of how viewpoint diversity would be increased by the transaction. This is a reform the FCC can and should adopt.

I also see a danger that after a station is sold to a minority buyer and the seller gets the tax certificate, the station may not stay minority owned. If minority ownership is only temporary, we may have paid a big tax price for very little social benefit. The FCC should adopt a policy that after a tax certificate sale, it won't approve another sale or transfer of that facility except to another minority owner for a good, long period—I suggest 5 years—unless the seller has made a diligent effort and cannot find another minority buyer.

I hope the Congress will encourage the FCC to reexamine its minority preference programs in light of some of the criticisms that have been made over the last several years. If the FCC does not act, I think Congress should adopt reforms through appropriate legislation.

Thank you very much.

[The prepared statement follows:]

STATEMENT OF BRUCE R. WILDE
BEFORE THE COMMITTEE ON WAYS AND MEANS
SUBCOMMITTEE ON OVERSIGHT
January 27, 1995

My name is Bruce Wilde. I make my living as a corporate and securities lawyer at a Wall Street law firm, but I am here today in my individual capacity, stating personal views, not those of my employer or any client. Incidentally, I worked as a news broadcaster in radio and television for 13 years before I became a lawyer.

I have always regarded myself as a liberal in political matters. I support color-blind action by government to protect civil rights and promote equal opportunity for all citizens of our country. However, I am troubled when the government uses race-conscious remedies in pursuit of social goals. Several years ago, when I was in law school, I became interested in the policies the FCC had adopted to promote minority ownership of broadcasting facilities. I studied these policies -- the tax certificate program under section 1071 of the tax code -- distress sales to minority buyers -- and the minority preference in choosing among competing applicants for broadcast licenses. I am not sure the FCC should have such policies at all. They violate the constitutional principle of equal protection, and it's always a question whether such violations are justified by the policy they seek to advance -- in this case increasing minority viewpoints on radio and television.

I came to the conclusion that the existing policies -- especially the tax certificate program which is the subject of this oversight hearing -- are not well designed and are vulnerable to abuse.

I wrote an article criticizing the tax certificate program which was published in the University of Pennsylvania Law Review. I am submitting a copy for the record and the Subcommittee's use. I would like to summarize the points I made then, which I think are still valid criticisms today, and the suggestions I made for reform of the program. I would like to point out that I do not currently practice communications or constitutional law, and therefore I do not hold myself out as a expert in these fields.

I believe the constitutionality of the program is doubtful. It was saved only by the blanket endorsement provided by Congress in the 1987 supplemental appropriation. I believe Congress should now withdraw that endorsement -- which I think would expose the program to much stricter due process scrutiny and encourage the FCC to adopt reforms.

Tax certificates are an uncontrolled, open-ended drain on tax revenues -- like an entitlement program. We really don't know what it's costing in lost tax revenues or what it might cost in the future. Also, the benefit the seller gets from a tax certificate is determined by the amount of capital gain realized by the seller. The benefit may be far more than would be necessary to encourage the sale to a minority enterprise -- and that's a waste.

The best answer, I think would be to replace the program with a direct spending program -- such as loan subsidies to help qualified minority entrepreneurs buy broadcast stations. That way Congress could determine how much to spend on the program and the FCC could direct the aid where it would do the most good in terms of increasing minority ownership.

If the program is to be kept in the tax system, there are some improvements that should be made.

The amount of deferred capital gain should be limited to no more than 30% of the selling price. I think that's plenty of incentive.

Another problem is that a seller can get a tax certificate without showing that minority persons will direct the day-to-day operation of the station after the sale or that viewpoint diversity will be increased. If we want minority viewpoints on the air, we need to require that the buyer have minority management as well as ownership as well as some showing of how viewpoint diversity will be increased. This is a reform the FCC should adopt.

I also see a danger that after a station is sold to a minority buyer and the seller gets a tax certificate, the station may not stay minority-owned. If minority ownership is only temporary, we've paid a big tax price for very little social benefit. The FCC should adopt a policy that after a tax certificate sale it won't approve a another sale or transfer of control of the station except to another minority buyer for a long period -- say five years -- unless the seller has made a diligent effort and can't find a minority buyer.

I hope that Congress will encourage the FCC to re-examine its minority preference programs in light of the criticisms that have been made and, if the FCC does not act, I think Congress should adopt reforms through appropriate legislation.

Thank you.

Chairman JOHNSON. Thank you very much.

I have only about 4 minutes to vote, so I am going to forgo questions of this panel and allow us to move on to the next.

But your testimony on the various points has been very clear on both the economics of this deal and some of the ways in which it could be restructured to overtly serve a social purpose, but in a way that was far more responsible economically.

Thank you. I appreciate it.

[Recess.]

Chairman JOHNSON. The subcommittee will come to order.

I appreciate the next panel being settled, and if the room will quiet down, please. I have to say I have a plane at 3:07. The Congress is adjourning at 3 o'clock, so we do want to have a chance to hear everyone's testimony.

Mr. Sutton, if you will begin, please. Welcome particularly on behalf of my colleague, Mr. Rangel, and his kind introduction of you.

I welcome you, sir.

STATEMENT OF PERCY E. SUTTON, CHAIRMAN EMERITUS, INNER CITY BROADCASTING CORP., NEW YORK, N.Y., ON BEHALF OF THE NATIONAL ASSOCIATION OF BLACK-OWNED BROADCASTERS, INC.

Mr. SUTTON. Thank you very much, Madam Chairperson. I am delighted to be here. I am most appreciative of my colleague, Congressman Rangel, who was here to introduce me. He is our Congressperson where I live, in the heart of Harlem, and I have come here because I think it important that this tax policy be sustained. I had a speech I wanted to deliver, Madam Chairperson, but I should now just place it in the record.

Chairman JOHNSON. Without objection, we certainly will do that.

Mr. SUTTON. I will deal with some of the issues, because I have heard fairness stated many times here. May I give you some background? I come from a place called Texas, and as a child I used to walk around on a farm with my 14 brothers and sisters, mother and father, and I used to talk into a corn cob: Good afternoon, ladies and gentlemen, this is Percy Sutton from high in the clouds of the Smith/Young Tower in San Antonio, Tex.

That was a dream. I could not even go into that radio station in San Antonio. I could not walk in. I could not walk on the sidewalk.

There is a river that runs through San Antonio now called the San Antonio River. It was just a creek when I was a child, but there was a large brown bear that swam in that creek known as the San Antonio River every day. But I could only visit that bear and that creek one day out of the year. That was called Juneteenth. June-teenth, June 19, was when blacks in Texas were notified of the emancipation proclamation. So we were allowed to go there.

It is against that background that I grew up; segregated schools. My father was my junior high school principal. My mother was my first grade teacher and six of my older brothers and sisters were my teachers before I graduated from high school. I was the youngest of the Suttons. My father and mother believed every little Sutton was going to learn through here, if possible; through here, if necessary.

We learned. My father said if you speak properly, do not put your elbows on the table while you eat, do not pick your nose in public, you will be accepted. I don't and I never did put my elbows on the table while I ate, don't pick my nose in public, and I try to speak the American English.

That, however, did not keep me from serving in the military for my country in World War II, as the Congressman described, but in a segregated unit, being put in jail because I sought to go into an officers' club, though I was an officer, and sought to exercise my right working to save the world for democracy.

I returned to the military after finishing law school and entered into the Korean conflict. I have a son, who is the present chairman of our company now, who served in Vietnam. I mention all of this because we talk about fairness.

I have spent enough years in government, both in the State legislature of New York, and as a chief executive of The Borough of Manhattan in New York City; we have made enough grants; I have participated in enough tax abatements to special groups, for the good of the whole, it was said. I participated, Madam Chairperson, in developing this policy that is before us now. I helped create the climate for it.

I want to talk about role models. I can attest to you, Madam Chairperson, that every owner, every black owner of a radio or television station in this country, whether gained by tax certificates or otherwise, is a role model in the community.

In my own community in central Harlem, across from Harlem Hospital, I live in a middle-income development. I have chosen not to move from Harlem. I live next door to a low-income development. Every morning there are at least five supplicants at my door who see me as a role model. Much of my time, three-quarters, I have evaluated my time, is spent working as a surrogate parent, participating in group discussions or otherwise seeking to advance my neighbors. I suggest to you that this is the role of all minority owners.

Now, I don't know Mr. Frank Washington. I know of him. I have seen him once. But I can say this to you, the focusing on Mr. Washington or an Oprah Winfrey or someone of that consequence, of that circumstance, is to injure the process. Why? Because that is indeed an aberration. One billion some-odd-dollar purchase price? Mr. Washington, I am proud of him. I am proud of him as someone from my community.

Why am I proud? Because it took me 8 years to buy my first radio station because no one would lend me money. I went to 67 institutions, including insurance companies.

In your State and in my State of New York and in Texas, I toured this country trying to raise $2.5 million to buy my first radio station. My first cable television station, my only one, it took me 7 years to raise the money. Why? Because blacks and minorities as a whole do not have access to money.

The purpose of this legislation, or the rule, was to see that minorities would have greater access and there would be diversification, if you will. I am tonguetied. However, with regard to the tax policy, this is minuscule. The amounts of money invested here in

the public policy issue is minuscule compared to the other tax benefits and losses that occur to this treasury.

[The prepared statement follows:]

STATEMENT OF PERCY E. SUTTON
CHAIRMAN EMERITUS
INNER CITY BROADCASTING CORPORATION
ON BEHALF OF THE NATIONAL ASSOCIATION
OF BLACK-OWNED BROADCASTERS, INC.

GOOD MORNING CHAIRMAN JOHNSON, AND MEMBERS OF THE SUBCOMMITTEE ON OVERSIGHT. ON BEHALF OF THE NATIONAL ASSOCIATION OF BLACK OWNED BROADCASTERS, INC. ("NABOB"), I THANK YOU FOR THE OPPORTUNITY TO PRESENT TESTIMONY TODAY.

I AM A LAWYER AND A BUSINESSMAN.

I WORK AND LIVE IN THE VILLAGE OF HARLEM IN NEW YORK CITY. HARLEM, THE HOME OF THE SCHOMBURG COLLECTION, THE APOLLO THEATRE, AND THE ANCESTRAL HOME FOR AFRICAN-AMERICAN CULTURE.

I AM A TRIAL LAWYER, AND I OPERATE A NUMBER OF BUSINESSES AROUND THE COUNTRY; SOME OF THAT BUSINESS IS IN RADIO OWNERSHIP AND OPERATION, TELEVISION PROGRAMMING AND CABLE TV OWNERSHIP.

I HAVE BEEN FASCINATED BY THE FIELD OF COMMUNICATIONS SINCE I WAS A CHILD IN TEXAS, LIVING WITH A MOTHER AND FATHER AND 14 BROTHERS AND SISTERS ON A FARM OUTSIDE OF SAN ANTONIO, TEXAS -- AND PRETENDING, OFTTIMES, THAT I WAS A DISC JOCKEY ON A MAJOR RADIO STATION IN SAN ANTONIO. IN WHICH AS A BLACK

PERSON, I WAS NOT EVEN ALLOWED TO ENTER.

NEVERTHELESS, I PRETENDED BY HOLDING A CORN COB TO MY MOUTH, AND STATING: "GOOD AFTERNOON LADIES AND GENTLEMEN, I AM PERCY SUTTON FROM HIGH IN THE CLOUDS IN THE SMITH/YOUNG TOWER IN SAN ANTONIO, TEXAS."

THOUGH I PRETENDED TO BE A DISK JOCKEY, I COULD NOT; AS THERE WERE NO OPPORTUNITIES FOR BLACKS (NEGRO, COLORED, OR AFRICAN-AMERICAN) TO BECOME DISK JOCKEYS IN SAN ANTONIO, TEXAS.

IN SPITE OF THE ABSENCE OF OPPORTUNITY, MY DREAM CONTINUED UNTIL AFTER SERVING IN BOTH WORLD WAR II AND THE KOREAN CONFLICT, I GAINED ACCESS TO AN ON-THE-AIR, VOLUNTEER POSITION WITH A LOCAL RADIO STATION, WLIB, IN HARLEM -- WHICH I LATER, THROUGH THE COURTESY AND ASSISTANCE OF THE OWNER, WAS ABLE TO BUY.

I AM HERE IN SUPPORT OF SECTION 1071 OF THE INTERNAL REVENUE SERVICE CODE WHICH HAS BEEN UTILIZED BY THE FEDERAL COMMUNICATIONS COMMISSION IN ITS TAX CERTIFICATE POLICY SINCE 1943, AND IN ITS OVERALL MINORITY OWNERSHIP POLICIES SINCE 1978.[1] AS THE OSTENSIBLE PURPOSE OF THIS HEARING IS TO ADDRESS THOSE ASPECTS OF THE COMMISSION'S TAX CERTIFICATE

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[1] SEE, STATEMENT OF POLICY ON MINORITY OWNERSHIP OF BROADCAST FACILITIES, 68 F.C.C. 2d 979, 42 RR 2d 1689 (1978).

POLICIES THAT ARE INTENDED TO PROMOTE DIVERSIFICATION OF OWNERSHIP THROUGH MINORITY PARTICIPATION, I SPEAK FIRMLY IN SUPPORT OF A POLICY THAT HAS PROVIDED SOME DESIGNATED BENEFITS TO MINORITIES. HOW CAN I SAY "BENEFITS"? HOW CAN SUCH TALK BE JUSTIFIED? I HOPE TO MAKE THAT POSITION CLEAR TO YOU THIS MORNING.

MY TESTIMONY TODAY IS PRESENTED IN TANDEM WITH THAT OF MR. JAMES WINSTON, THE EXECUTIVE DIRECTOR OF THE NATIONAL ASSOCIATION OF BLACK-OWNED BROADCASTERS (NABOB), AN ASSOCIATION OF WHICH I WAS A CO-FOUNDER AND REMAIN A STAUNCH SUPPORTER. I MENTION THIS BECAUSE I WILL ADDRESS THE BROAD POLICY CONSIDERATIONS, WHILE MR. WINSTON WILL ADDRESS THE LEGAL CONSIDERATIONS.

AS A VETERAN OF THE CIVIL RIGHTS ERA, I REMAIN VERY ACTIVE IN THAT COMMUNITY AND TRAVEL THIS COUNTRY SPEAKING TO VARIOUS ORGANIZATIONS, MANY OF WHICH ARE PROFOUNDLY TROUBLED BY WHAT ARE PERCEIVED TO BE VERY UNSUBTLE ATTEMPTS TO "ROLL BACK THE CLOCK" ON AFRICAN-AMERICANS. I OWN A TALK RADIO STATION IN THE CITY OF NEW YORK, AND I AM VERY UNSETTLED BY THE NUMBER OF OUR CALLERS WHO SINCERELY FEAR THAT THE MUCH TOUTED "CONTRACT WITH AMERICA" IS REALLY A VEILED "CONTRACT ON MINORITIES."

IT'S NO SECRET THAT MINORITIES, SPECIFICALLY MINORITIES OF

AFRICAN DESCENT, HAVE NOT HAD THE "TRADITIONAL" OPPORTUNITIES MADE AVAILABLE TO THEM HISTORICALLY. IN FACT, IN THE PAST I HAVE REFERRED TO THIS AS OUR "BLACK TAX." WHEN I SAY "BLACK TAX" I DO NOT SAY THIS TO BE OFFENSIVE. NO. I SAY THIS SADLY BECAUSE IT IS A SIMPLE REALITY THAT AFRICAN-AMERICANS, AND PERHAPS CERTAIN OTHER GROUPS IN AMERICA, LIVE IN VASTLY DIFFERENT WORLDS. BUT THIS IS ESPECIALLY TRUE OF AFRICAN-AMERICANS, BECAUSE WE ARE ALWAYS "DISTINGUISHABLE" AND WE HAVE YET TO ESCAPE THAT STATUS OF BEING FIRST AND ALWAYS DISTINGUISHED BY THE COLOR OF OUR SKIN. HISTORICALLY, THAT DISTINCTION HAS DETERMINED WHERE WE LIVED, WHAT TYPE OF JOBS WERE OPEN TO US, AND WHAT OPPORTUNITIES MIGHT BE AVAILABLE TO US.

RECOGNITION OF THE EFFECT THAT CERTAIN HISTORICAL DISTINCTIONS HAD UPON MINORITY REPRESENTATION IN BROADCASTING LED THE COMMISSION TO ATTEMPT IN 1978 TO ADDRESS THE NEED FOR DIVERSITY OF OWNERSHIP BY ISSUING ITS POLICY STATEMENT ON MINORITY OWNERSHIP OF BROADCAST FACILITIES (THE "POLICY STATEMENT"). IN THAT STATEMENT, THE COMMISSION ACKNOWLEDGED THE "DEARTH OF MINORITY OWNERSHIP IN THE BROADCAST INDUSTRY" AND SOUGHT TO PROMOTE OWNERSHIP PRINCIPALLY THROUGH RELIANCE UPON THE TAX CERTIFICATE. WHAT THE COMMISSION TRIED TO ACCOMPLISH WAS

THE CREATION OF A CLIMATE IN WHICH THE INDUSTRY WOULD FIND IT ATTRACTIVE TO DO BUSINESS WITH MINORITIES, JUST AS THE INITIAL USES OF §1071 MADE IT ATTRACTIVE TO FURTHER OTHER COMMISSION POLICIES, SUCH AS THE BAN ON CROSS-OWNERSHIP. THE GOVERNMENT HAS ALWAYS USED INCENTIVES OF ONE FORM OR ANOTHER TO MOVE BUSINESS. WHETHER IT IS THE INTEREST RATE OR THE GATT TREATY, IT IS CLEARLY UNDERSTOOD THAT THE "CARROT AND STICK" WORKS. (THE FALLACY IN THE ATTACKS ON INCENTIVE POLICIES IS THAT THEY ATTEMPT TO SUGGEST THAT YOU CAN ACCOMPLISH CHANGE WITHOUT CHANGING ANYTHING. THE CIVIL RIGHTS ACT OF 1968 WAS PASSED LESS THAN 30 YEARS AGO. AS MUCH AS ALL OF US WOULD LIKE TO THINK OF AMERICA AS A FREE AND OPEN SOCIETY, 30 YEARS IS TOO SHORT A TIME IN WHICH TO ERASE THE PROFOUND EFFECTS OF INSTITUTIONAL RACISM. IT WAS ONLY TEN YEARS AFTER THE ACT'S PASSAGE THAT THE COMMISSION ENACTED ITS POLICIES).

SUBSEQUENT TO THE ISSUANCE OF THE 1978 POLICY STATEMENT, THE COMMISSION ENTERED INTO ITS "DEREGULATORY" PHASE. THROUGHOUT THE 80'S, WE EXPERIENCED THE RELAXATION OF THE RULES GOVERNING BROADCAST STATION OWNERSHIP, THE INCREASE IN COMPETITION FROM NEW AND NON-BROADCAST SERVICES, AND CONTINUAL ASSAULTS ON EVERY ASPECTS OF THE MINORITY OWNERSHIP POLICIES. THE EFFECT OF EACH OF THESE ACTIONS UPON

MINORITIES WAS TO ENDANGER THE FEW GAINS THAT MINORITIES HAD MADE, AND MAKE IT THAT MUCH MORE DIFFICULT FOR COMPANIES TO BECOME, OR REMAIN, COMPETITIVE -- EVEN THOSE MINORITY COMPANIES WHO MIGHT HAVE APPEARED TO HAVE "MADE IT." JUST LAST WEEK, SENATOR PRESSLER, CHAIR OF THE SENATE COMMERCE COMMITTEE, INVITED MOST OF THE "MAJOR" TELECOMMUNICATIONS COMPANIES TO WASHINGTON TO DISCUSS THEIR CONCERN OVER HIS PROPOSED "SUPERHIGHWAY" LEGISLATION. NO MINORITY COMPANIES WERE PRESENT. WHAT WOULD THESE MULTIBILLION DOLLARS CORPORATIONS VIEW AS AN ISSUE OF CONCERN? THEIR CONTINUING ABILITY TO REMAIN COMPETITIVE IN A CHANGING REGULATORY ENVIRONMENT. ARE THEY SEEKING "PREFERENTIAL" TREATMENT? OF COURSE THEY ARE! I AM NOT SO NAIVE AS TO THINK THAT IN ATTEMPTING TO PLACATE THE PROBLEMS THAT THE TELCOS HAD WITH THE 1994 LEGISLATION THAT SOME "BENEFITS" WERE NOT PUT ON THE TABLE. I AM JUST AS CERTAIN THAT THE HOUSE'S CURRENT BILL WILL REFLECT A SIMILAR WILLINGNESS TO MEET THE DEMANDS AND THE "NEEDS" OF THE TELCOS AND CABLE COMPANIES WHO HAVE BEEN INVITED TO PARTICIPATE IN THE DRAFTING OF THE LEGISLATION. THERE WILL SURELY BE PROVISIONS INCLUDED TO ENSURE THAT THESE POWERFUL COMPANIES WILL NOT SUFFER WHILE MAKING THE TRANSITION INTO COMPLIANCE WITH THE NEW ACT. ANY SUCH PROVISIONS WILL

AFFECT THE TREASURY. AND YET, THESE EFFORTS ARE LAUDED BY ALL PARTIES AS NECESSARY FOR THE FUTURE GROWTH OF THE TELECOMMUNICATIONS INDUSTRY. WHILE THE VERY CLEAR SIGNAL OF THE TELCO BILL NEGOTIATIONS IS THAT THIS IS SOMETHING THAT IS GOOD FOR BUSINESS, DESPITE THE BENEFITS THAT WILL BE ACCORDED TO CERTAIN OF THE INDUSTRIES, ASSAULTS UPON THE FEW INCENTIVES DIRECTED AT MINORITIES SENDS A VERY DIFFERENT SIGNAL. THE CLEAR MESSAGE IS THAT ENDORSEMENT OF MINORITY PARTICIPATION IS GONE, REPLACED BY AN ATTITUDE THAT ESSENTIALLY STATES: "BE THANKFUL FOR WHAT YOU'VE GOT."

THE PUBLIC, THE INDUSTRY, AND THE PRESS ARE ALL VERY ATTUNED TO GOVERNMENTAL SIGNALS. WILL THERE BE A SIGNAL THAT MINORITY OWNERSHIP REMAINS A POSITIVE FOR THIS COUNTRY?

AS MINORITY BUSINESSES BECOME LARGER AND MORE VIABLE, THERE IS A DIRECT IMPACT UPON THE ECONOMIC HEALTH OF THEIR SURROUNDING COMMUNITIES. EVERY ACQUISITION BY A MINORITY CAN PROVIDE A NEW SOURCE OF EMPLOYMENT, A NEW HEALTH PLAN, A BETTER CHANCE OF BECOMING A TAX-PAYING MEMBER OF SOCIETY. BUT OUR BUSINESSES CANNOT GROW ON WISHES AND PRETENDING. WE CANNOT PRETEND THAT HISTORIC AND INSTITUTIONALIZED RACISM MAGICALLY DISAPPEARED IN 1968. NOR CAN WE IGNORE THEIR LINGERING EFFECTS UPON OUR ACCESS TO CAPITAL, OR OUR

ABILITY TO PARTICIPATE IN THE LARGER OPPORTUNITIES. RACE NOT WITHSTANDING, NO ONE ENTERS AN INDUSTRY WITH THE INTENT TO BECOME ITS PERMANENT UNDERCLASS. IN TODAY'S PARLANCE, EVERY ONE SEEKS TO "GROW" THEIR BUSINESS, AND GROWTH MEANS LARGER OPPORTUNITIES TO EXPAND. AND JUST AS THE TWO TELECOM SUBCOMMITTEES HAVE RECOGNIZED, BUSINESS TRADITION SUGGESTS THAT MOST DEALS REQUIRE SOME INCENTIVE ON THE PART OF EACH PARTY TO GO FORWARD IF AN AGREEMENT IS TO BE REACHED.

I WILL CLOSE WITH WHAT I FEEL IS A CLEAR EXAMPLE OF THE COMMISSION'S APPROACH TO ACHIEVING PARITY. WHEN JUST TEN YEARS AGO THE COMMISSION DECIDED TO BREAK-UP AT&T'S MONOPOLY OVER THE TELEPHONE INDUSTRY, IT DID SO BECAUSE IT DECIDED THAT COMPETITION WAS GOOD AND THAT THE "OTHER COMMON CARRIERS" WERE DISADVANTAGED BY THAT MONOPOLY. THE COMMISSION FURTHER DETERMINED THAT BECAUSE OF THAT HISTORIC DISADVANTAGE, IT COULD ACT ON BEHALF OF THE OTHER CARRIERS AND JUSTIFIABLY ENACT POLICIES THAT WOULD ACCORD THE OTHER COMMON CARRIERS CERTAIN ADVANTAGES OVER AT&T AND ITS LOCAL PHONE SUBSIDIARIES. ONE OF THOSE "POOR" OTHER COMPANIES WAS TODAY'S GIANT MCI. THE TAX CERTIFICATE POLICY, IN BOTH ITS MINORITY AND NON-MINORITY APPLICATIONS, WORKS BECAUSE IT PROVIDES A NECESSARY INCENTIVE FOR BUSINESSES TO MOVE COMMISSION POLICIES FORWARD, WHETHER THOSE POLICIES BE

CROSS-OWNERSHIP, CABLE/BROADCAST BREAKUPS, OR MINORITY OWNERSHIP. THE POLICY, IN ANY OF ITS MANIFESTATIONS, HAS ALWAYS BEEN DIRECTED AT THE FACT OF THE TRANSACTION, NOT THE SIZE. MINORITY ENTREPRENEURS ARE BUSINESSPEOPLE NOT UNLIKE ANY OTHER ENTREPRENEURS. WHAT WE LACK AND NEED IS ACCESS TO THE MAJOR MARKETPLACE. WE SEEK ONLY WHAT MCI AND THE NON-BELL COMMON CARRIERS SOUGHT--SOME INCENTIVE OR MECHANISM TO OVERCOME AN HISTORIC UNEQUAL DISTRIBUTION OF OPPORTUNITY. THANK YOU.

ONCE AGAIN I THANK YOU FOR THE OPPORTUNITY TO MAKE THIS PRESENTATION.

Chairman JOHNSON. Thank you, Mr. Sutton.

I appreciate your testimony and your eloquence as to the importance of access into markets. The importance of role models and the importance of people succeeding so others can see success are absolutely important to me.

I think it is concerning that we have in place a public policy that we know so little about. We do not know to whom it gave money, we don't know how much it gave, we don't know whether it affected diversity, we don't know whether there was real management control. Now, that is not to undermine the importance of the policy, but it is to say we have not been doing our job and we should find out.

To the extent you are interested, we will be happy to share with you the information we get from the agencies as they provide us with better information and look at how we can make this policy more accountable, but at the same time, achieve its goal.

Mr. SUTTON. You did note in the testimony that very few minorities actually benefit. What that does, the policy does, is it gives access to the persons who may be willing to sell, even though we may have to pay market price in buying it.

Chairman JOHNSON. I understand that. Thank you very much.

Mr. Winston.

STATEMENT OF JAMES L. WINSTON, EXECUTIVE DIRECTOR AND GENERAL COUNSEL, NATIONAL ASSOCIATION OF BLACK-OWNED BROADCASTERS, INC.

Mr. WINSTON. Good afternoon, Chairman Johnson, members of the subcommittee. On behalf of the National Association of Black-Owned Broadcasters, thank you for the opportunity to present testimony today on section 1701 of the Internal Revenue Code.

Chairman JOHNSON. Excuse me, could you pull the microphone closer?

Mr. WINSTON. Sure. I have the distinct disadvantage here of having to speak after Mr. Sutton.

Chairman JOHNSON. You also will be more severely controlled by the 5-minute limit. Out of respect, he was given latitude.

Mr. WINSTON. But it is a pleasure to have the opportunity to follow his comments, because he is one of the role models that has guided NABOB since 1976.

It has been suggested that the FCC has not implemented the tax certificate policy in a manner which has promoted the ownership of broadcast facilities by minorities. One of the theories espoused by the opponents of the policy is the policy has been abused in sham transactions in which companies identified to the FCC as minority owned are actually controlled by nonminority individuals, who put forth minority individuals to front for them.

The history of the minority tax certificate policy refutes this claim.

As noted, the minority tax certificate policy has been operated by the FCC since 1978. During that time the FCC has issued approximately 300 tax certificates. During that same period, the FCC has approved approximately 15,900 transactions. Tax certificate transactions, therefore, constituted only 1.9 percent.

Chairman JOHNSON. Those were not all license transactions.

Mr. WINSTON. Beg pardon.

Chairman JOHNSON. Those were not all license transactions, were they?

Mr. WINSTON. What do you mean? I am not sure I understand the question.

Chairman JOHNSON. Licensure transactions.

Mr. WINSTON. Oh, yes. In other words, you have to understand there are approximately 11,000 broadcast facilities in America today. So those are transactions of broadcast stations being bought and sold: 15,900.

Chairman JOHNSON. Thank you.

Mr. WINSTON. OK. Therefore, to suggest that—if this program is such a boondoggle, it would generate a lot more activity than it has.

The fact is the vast majority of these tax certificates were issued to companies which were all almost 100 percent minority owned. The entrepreneurs who controlled these companies put together their transactions and built their companies with little or no attention from or support from the nonminority media. However, it now appears that press speculation of one or two possible abuses of the policy have galvanized a tidal wave of opposition to the policy. Such opposition is unfounded.

The FCC, on occasion, may be presented with a proposed transaction in which individuals may seek to circumvent the intent of the policy. However, this subcommittee and most certainly the full committee, has adopted over the years numerous tax policies which favor one group of individuals or companies with tax benefits.

When the subcommittee and full committee adopt and renew such policies, you are obviously mindful such policies must be implemented by the Internal Revenue Service in a manner such that unscrupulous persons would not be allowed to abuse those policies. Thus, you have given the IRS extensive enforcement authority and resources to detect and prevent such abuses.

The FCC, like the IRS, has the authority and resources to detect and prevent abuses of the tax certificate policy. The FCC uses that authority to effectively preclude such abuses.

This subcommittee does not routinely eliminate important tax benefits for individuals in industries for which it has created tax initiatives merely because the IRS may uncover some attempts to abuse those policies. The subcommittee should similarly take no such action against the minority tax certificate policy.

The FCC's tax certificate policy, in any announced transaction which may be causing this subcommittee concern, has received so much publicity that the FCC will be forced to scrutinize any new tax certificate applications extremely thoroughly to assure that no abuse of the policy is occurring. We are certain that the FCC will reject any transactions which fail to comply with the objectives of the policy. NABOB fully supports such close scrutiny.

The only parties who will suffer by elimination of the policy are the honest, dedicated entrepreneurs who will never get an opportunity to use the policy because of this subcommittee's concern about potential abuses. We are left, then, to determine if there are other concerns which warrant elimination of the policy.

We have heard this is not a minority ownership issue but a deficit reduction issue. But is a potential loss of revenues for the Treasury a reason to single out the minority tax certificate policy for elimination? No. This subcommittee and the full committee routinely approve tax measures which result in lost revenues to the Treasury. Congressman McDermott gave several examples earlier today.

Our objective in pointing out these provisions is not to question any of them, to suggest that any of them constitutes bad policy. Rather, the purpose is to point out there is nothing in the FCC tax certificate that is outside the realm of the kinds of policies this subcommittee approves each year.

The question has been asked today should the policy be abolished because there are ways of encouraging minority ownership other than allowing nonminority companies tax deferrals resulting to minorities. The simple answer is, we in the FCC have been looking for almost 20 years and we have yet to find one.

[The prepared statement follows:]

TESTIMONY
OF
JAMES L. WINSTON
EXECUTIVE DIRECTOR AND GENERAL COUNSEL
OF
THE NATIONAL ASSOCIATION
OF
BLACK OWNED BROADCASTERS, INC.
BEFORE
COMMITTEE ON WAYS AND MEANS
SUBCOMMITTEE ON OVERSIGHT

January 27, 1995

Good morning Chairman Johnson, and members of the Subcommittee on Oversight. On behalf of the National Association of Black Owned Broadcasters, Inc. ("NABOB"), I thank you for the opportunity to present testimony today on Section 1071 of the Internal Revenue Code.

NABOB was organized in 1976 as a response to the abysmal underrepresentation of Black Americans in the communications industry. Since its inception, NABOB has grown into a major trade association representing the interests of 178 Black-owned commercial radio stations and 20 commercial television stations around the country. Additionally, NABOB counts among its associate membership: law firms, station brokers, national rep firms, financial institutions and a variety of other organizations involved in broadcasting, cable television and common carrier services.

As the voice of the Black broadcast industry, NABOB has been instrumental in shaping national government and industry policies to improve the opportunities for success for Black and all other minority station owners.

The press coverage in anticipation of this hearing has positioned this as a hostile attack upon Section 1071. I hope that through our testimony today, we can demonstrate to the Subcommittee that there is no reason for this Subcommittee to be hostile toward Section 1071. Indeed, we believe that this Subcommittee should embrace Section 1071 as legislation which both Republican and Democratic members of the House have supported in the past and should strive to improve in the future.

It is apparent that one recent proposed transaction has generated a great deal of press interest in Section 1071, and this, in turn, has focused this Subcommittee's attention. However, a review of the history of Section 1071 clearly demonstrates that Section 1071 has been accomplishing precisely what it should be doing and that it should be preserved and possibly expanded.

Chairman Johnson's press advisory setting forth the focus of this hearing asks a series of questions which the Subcommittee will seek to answer today. Those questions can serve as an efficient tool for understanding and appreciating the importance and value of Section 1071.

The first question asked in the press advisory is: "Whether the FCC's 1978 policy is consistent with the underlying intent of Section 1071?" First it should be pointed out that Section 1071 was enacted in 1943. In 1943, the communications industry was owned and controlled and completely dominated by non-minorities. Indeed, at the time of the adoption of Section 1071, all of American life, including this House and this Subcommittee were similarly controlled and dominated. Moreover, 1943 was eleven years before the Supreme Court's decision in Brown v. Board of Education, 347 U.S. 483 (1954), which means that legal segregation as approved by the U.S. Supreme Court in 1896, in Plessy v. Ferguson, 163 U.S. 537 (1896) was still the law of the land.

Therefore, if the question this Subcommittee seeks to have answered today is: "Did Congress direct the FCC to create the minority ownership policy using Section 1071, when Congress adopted Section 1071 in 1943?" this hearing can be over very quickly. However, we submit that this is not the correct manner for viewing the question raised in the press advisory. The proper method for viewing the question raised in the press advisory is: "In light of Congress's treatment of Section 1071 over the seventeen years since the FCC adopted the minority ownership policy, is the FCC's 1978 policy consistent with the underlying intent of Section 1071?" The answer to this question is a resounding "yes," and it is this history on which this Subcommittee should focus.

As the Subcommittee is well aware, Section 1071 was not a new provision when the FCC included the promotion of minority ownership as a policy which could be used to allow a grant of a tax certificate. Section 1071 was adopted by Congress in 1943 to allow the gain from the sale or exchange of broadcast facilities to be deferred in cases where the sale or exchange is certified by the FCC "to be necessary or appropriate to effectuate a change in a policy of, or the adoption of a new policy by, the Commission with respect to the ownership and control of radio broadcasting stations . . . ." 26 U.S.C. § 1071(a) (1988).

After its enactment in 1943, the Commission used Section 1071 to promote its policy of diversification of ownership and control of the broadcast industry. The FCC allowed companies to obtain a tax certificate under section 1071 to defer the gain on the sale of broadcast stations in circumstances in which the FCC determined that a station owner possessed too great a control over the dissemination of news and information in a single market. Thus, when the FCC determined that a single owner held an excessive degree of ownership and control over daily newspaper, radio stations, television stations and/or the cable television systems in a given market, the FCC granted a tax certificate to the owner if the owner sold certain of its broadcast holdings.

In 1978, the FCC turned to Section 1071 to address a related issue of diversification of ownership of the mass media. The nature and magnitude of the problem which confronted the Commission in 1978 was fully considered and analyzed by the United States Supreme Court in 1990, when the Court addressed the constitutionality of the minority ownership policies adopted by the Commission in 1978. In that case, Metro Broadcasting v. FCC, the Supreme Court observed that the

FCC adopted its minority ownership policy after several years of consideration of the problem of the lack of participation by African Americans and other minorities in the ownership and control of broadcast facilities. Metro Broadcasting v. FCC, 497 U.S. 547 (1990).

In Metro, the Court noted that in 1968, the FCC first addressed the lack of involvement of African Americans and other minorities as employees in the broadcast industry. Id. at 554-555. The Court pointed out that the FCC, in 1968, recognized that a diverse work force in the broadcast industry was essential if minorities were to be able to achieve their First Amendment right to freedom of expression. Id. The Court noted that, after several years of developing, implementing and enforcing equal employment opportunity ("EEO") rules, the FCC realized that it had not achieved any significant increase in minority control of broadcast facilities. Id. at 554-556. The Court pointed out that it was only after its inability to increase control of broadcast facilities by minorities through its EEO rules between 1968 and 1978, that the FCC turned its attention to policies designed to further ownership of broadcast facilities by minorities. Id.

The Court then analyzed two aspects of the FCC's minority ownership policy, other than the tax certificate. The Court noted that the petitioner in the Metro case challenged the constitutionality of the minority ownership policy as not having been created and implemented within the FCC's statutory authority from Congress. The Court examined the extensive legislative history surrounding the minority ownership policy and determined that the FCC had developed and implemented the policy with statutory authority from Congress. Specifically, the Court reviewed the numerous legislative determinations, beginning in 1988, by Congress that the minority ownership policy as adopted by the FCC in 1978, and as amended and expanded up to that date, should not be altered by the FCC. Id. at 560. The Court ruled that this series of successive legislative actions established fully that the policy as adopted by the FCC in 1978 reflects the intent of Congress on this issue.

This analysis by the Supreme Court allows this Subcommittee to fully answer all of the questions raised in the press advisory: (1) the tax certificate policy is consistent with the underlying intent of Section 1071, in that it furthers an important public policy objective; (2) the FCC's administration of Section 1071 has been approved by Congress and does not constitute an impermissible exercise of legislative authority; (3) Section 1071 fosters minority ownership of broadcast facilities; and (4) the policy is a necessary and appropriate means of achieving this goal.

Therefore, NABOB submits that those who oppose the continued operation of Section 1071 to foster minority ownership must come forward with justification for reversing the determination of the U.S. Supreme Court that promotion of minority ownership is an appropriate public policy objective for the FCC. We submit there is no basis for reversing that determination.

To support an elimination of Section 1071, the opponents of the policy should demonstrate either that: (1) the objective of the policy has been achieved and the

policy is no longer needed, or (2) the FCC's administration of the policy has not actually promoted minority ownership.

The record clearly refutes either such assertion. First, the objective of the policy has not been accomplished. The objective of the minority tax certificate policy is to help facilitate ownership of broadcast facilities by African Americans and other minorities at a level commensurate with their proportion in the American population. The circumstances which led the FCC to adopt the tax certificate policy in 1978 have not changed significantly. In 1978, African Americans constituted approximately 10% of the American population, and yet owned less than 1% of all then licensed radio and television stations.

Today, the National Telecommunications and Information Administration reports that, while now comprising approximately 12% of the American population, African Americans own less than 2% of all television and radio stations. Report of the National Telecommunications and Information Administration, September 1994. These numbers clearly demonstrate that the situation which necessitated the adoption of the minority tax certificate policy has not changed significantly since the adoption of the policy. In fact, just this past September, Vice President Al Gore stated at the NABOB Fall Conference that these current ownership statistics are "a disgrace." Broadcasting & Cable, September 19, 1994, page 6.

The next ground upon which the opponents would seek to over-turn the policy is that the FCC has not implemented the policy in a manner which has promoted the ownership of broadcast facilities by minorities. The theory espoused by such opponents of the policy is that the policy has been abused in "sham" transactions in which companies identified to the FCC as minority owned are actually controlled by non-minority individuals who put forward minority individuals to "front" for them. The history of the minority tax certificate policy refutes this claim.

As noted, the minority tax certificate policy has been operated by the FCC since 1978. During that time, the FCC has issued approximately 300 tax certificates. During that same period, the FCC has approved approximately 15,900 transactions. See Broadcasting & Cable, March 7, 1994, p. 37, and January 2, 1995, page 46. Tax certificate transactions therefore constituted only 1.9% of broadcast transactions since 1978.

Moreover, the vast majority of these tax certificates were issued to companies which were all or almost 100% minority owned. The entrepreneurs who controlled these companies put together their transactions and built their companies with little or no attention from or support from the non-minority media. However, it now appears that press speculation of one or two possible abuses of the policy have galvanized a tidal wave of opposition to the policy. Such opposition is unfounded.

The FCC on occasion may be presented with a proposed transaction in which individuals may seek to circumvent the intent of the policy. However, this Subcommittee, and most certainly the full Committee, has adopted over the years numerous tax policies which favor one group of individuals or companies with tax

benefits. When the Subcommittee and full Committee adopt and renew such policies, you are obviously mindful that such policies must be implemented by the Internal Revenue Service in a manner such that unscrupulous persons will not be allowed to abuse those policies. Thus, you have given the IRS extensive enforcement authority and resources to detect and prevent such abuses.

The FCC, like the IRS, has the authority and the resources to detect and prevent abuses of the tax certificate policy. And the FCC uses that authority to effectively preclude such abuses. This Subcommittee does not routinely eliminate important tax benefits for individuals and industries for which it has created tax policy initiatives, merely because the IRS may uncover some attempts to abuse these policies. The Subcommittee should similarly take no such action against the minority tax certificate policy.

The FCC's tax certificate policy, and any announced transaction which may be causing this Subcommittee concern, have received so much publicity that the FCC will be forced to scrutinize any new tax certificate applications extremely thoroughly to assure that no abuses of the policy are occurring. We are certain that the FCC will reject any transactions which fail to comply with the objectives of the policy. NABOB fully supports such close scrutiny.

The only parties who will suffer by an elimination of the policy, are the honest, dedicated entrepreneurs, who will never get an opportunity to use the policy, because of this Subcommittee's concern about potential abuses. The Subcommittee should not punish those who can properly benefit from the policy, when the FCC has been preventing, and can in the future continue to prevent, any potential abuses.

We are then left to determine if there are other concerns which warrant an elimination of the policy. We have heard that this is not a minority ownership issue, but a deficit reduction issue. But, is the potential loss of revenue for the Treasury a reason to single out the minority tax certificate policy for elimination? No.

This Subcommittee and the full Committee routinely approve tax measures which result in lost revenues for the Treasury. In fact, the staff of the Joint Committee on Taxation prepares a report of the Estimates of Federal Tax Expenditures each year, which shows this Committee an estimate of the tax expenditure consequences of its various policies. The November 9, 1994 report shows dozens of tax provisions which result in lost potential income to the Treasury which this Subcommittee has approved. For example:

- Exclusion of income of foreign sales corporations -- $1.4 billion
- Deferral of income of controlled foreign corporations -- $1.1 billion
- Inventory property sales source rule exception -- $3.5 billion
- Expensing of exploration and development costs -- $0.5 billion

- Exclusion of investment income on life insurance and annuity contracts -- $0.8 billion

- Special treatment of life insurance company reserves -- $2.1 billion

- Deduction of unpaid property loss reserves for property and casualty insurance companies -- $1.6 billion

- Depreciation of rental housing in excess of alternative depreciation system -- $1.0 billion

- Depreciation of equipment in excess of alternative depreciation system -- $19.9 billion

- Reduced rates for first $10,000,000 of corporate taxable income -- $43.9 billion

Included in this report is a mere $0.1 billion estimate for the FCC minority tax certificate policy. Therefore, if the objective is to eliminate the budget deficit, there would appear to be many much "fatter" policies to review.

Then perhaps the problem is not the size of the cost to the Treasury, but a "social engineering issue." Well, again this would not seem to justify singling out this policy. The Tax Expenditure Estimate also lists numerous provisions which clearly constitute social engineering:

- Deductibility of mortgage interest on owner-occupied residences -- $53.5 billion

- Deductibility of property tax on owner occupied homes -- $13.7 billion

- Exclusion of capital gains at death -- $12.7 billion

Our objective in pointing out these provisions is not to question any of them or to suggest that any of them constitutes bad policy. Rather, the purpose is to point out that there is nothing in the FCC tax certificate that is outside the realm of the kinds of policies this Subcommittee approves each year.

The next question then is: should the policy be abolished because there are better ways of encouraging minority ownership than allowing non-minority companies tax deferrals for selling to minorities? The simple answer is that we and the FCC have been looking for almost twenty years, and we have yet to find one. As stated above, the FCC adopted the tax certificate policy after ten years of trying to promote meaningful participation by minorities in broadcasting. What the FCC found was that the only time minorities learned that desirable broadcast facilities were for sale was after the deal was signed and the sale was announced in the trade press. The trading in the most desirable broadcast facilities was, and still is, conducted in a closed circle of the largest companies.

No one called minorities to buy the most desirable facilities, because they were the most expensive. It was assumed that a minority buyer would have difficulty obtaining financing for a major acquisition, and the seller would have to wait for the minority to go to several lending sources before he could finance a deal, if he could finance it all. And, unfortunately, that assumption was usually correct.

But, the tax certificate caused the telephones of some minority buyers to start ringing. Non-minority sellers realized that, if they could defer paying capital gains taxes, it would be worthwhile waiting for the minority buyer to arrange financing. The result is that the tax certificate generated some telephone calls to minority buyers. It did not produce a flood of such calls (300 tax certificate deals out of 15,900 broadcast deals since 1978). But it produced some where none had been received before. If the policy is eliminated, many prospective minority buyers can plan to disconnect their telephones, because no one will be calling to sell them broadcast facilities.

Then, we get to the final question which seems to be driving this hearing: At some point should a deal be considered too "big" to justify a tax certificate? To answer this question the Subcommittee must consider the underlying purpose of the tax certificate policy. The policy is intended to enable minorities to have an effective means of asserting their First Amendment rights through the ownership and control of broadcast facilities. To date, the tax certificate policy has fallen far short of producing such a result. The companies which control the dissemination of news, information and opinion in this country are all multibillion dollar businesses. If minorities are to be able to compete with the companies which currently dominate this industry, they must have at least some companies of substantial size.

In its seventeen year history, the tax certificate has never had an impact which could be said to have allowed minorities to gain a substantial ownership position in this industry. Although minorities own approximately 3% of broadcast stations, that ownership represents only approximately 0.5% of the gross revenues of the broadcast industry. One transaction will not significantly change that situation. At such time as the policy produces minority ownership in the broadcast industry which even approaches the proportion of minorities in this society, we would agree that some sort of limit should be placed on the policy. For now, such a result is nowhere in sight.

Therefore, we submit that the Subcommittee should take no action against the FCC's minority tax certificate policy. The policy has been approved by the Congress as consistent with the intent of Section 1071, the FCC has Congressional authority to continue the policy, the policy is a necessary and appropriate means of achieving minority ownership, and it does foster minority ownership. In fact, the policy should be expanded rather than curtailed.

Thank you.

Chairman JOHNSON. Thank you for your testimony.

Close scrutiny does matter, and if you have any thoughts about how we go about that, you are welcome to submit them.

We are going to have to reduce the time to 3 minutes. I am sorry about that, but in order for everybody to be heard, we do have to do that. So if you will proceed promptly.

STATEMENT OF TYRONE BROWN, ESQ., ON BEHALF OF BLACK ENTERTAINMENT TELEVISION, SYNCOM FUNDS, AND RADIO ONE, INC.

Mr. BROWN. Madam Chair, my name is Tyrone Brown. I was a Commissioner at the FCC when the tax certificate policy was established. I worked for it within the Commission. I supported it. I voted for it and I continue to support it now.

We just heard that in the 17 or so years since the policy was established, we have had a total of 300 tax certificate transactions out of 15,000, nearly 16,000 total transfers. If this policy were providing major windfalls, as a general matter, to either side of the transaction, we certainly would see many, many more transactions structured around the tax certificate than have occurred. I will come back to that at the end of my points, if I may.

Chairman JOHNSON. Mr. Hancock will be able to stay so we will be able to resume the 5 minutes.

Mr. BROWN. OK. I will still try to stay——

Chairman JOHNSON. That is all right, your experience is very interesting.

Mr. BROWN. I got into the broadcasting field as a lawyer for the Washington Post broadcast operations. When I got into the field, one of the early transactions that I was involved in on behalf of the Post was the acquisition of a television station. That acquisition took place the way that all transactions, radio and television, took place at that time.

It was a small group of very courtly people, very courtly men, who acted through brokers, who had all the information about which broadcast stations were available and which ones were not. There were not any black people, there were not any Hispanics, there were not any women. That was the way we did business in America in 1974 and 1975.

Now, I should say about the Washington Post, at the same time I was involved in that transaction, they transferred an FM station to Howard University. That station has become one of the most successful, leading minority-controlled stations in this community. So I am not knocking the Washington Post.

But, they did television transactions the way transactions were done at that time. No black, no Hispanic, no Native American, no female-based business was going to get the information to be able to get into this marketplace.

Well, 4 years after that, I went to the FCC as a Commissioner. When one young man named Frank Washington came to me and said, well, what about section 1071 and what about if the Commission did try to do something about the one-half of 1 percent—because that is what it was then—of these licenses passed out by government that are in the hands of minorities?

What if the Commission said we will encourage that; could they then operate under section 1071? I said, "Hey, maybe that will work. You know what it will do? It will mean that minority individuals will get information about available stations. When they indicate an interest in getting into the business, and in order to do that, they will have to have the wherewithal, they will have to have some kind of access to capital, they will have to have experience. But somebody will talk to them because they are carrying a piece of paper. Someone will talk to them. These brokers will let them know that the opportunities are out there. When they knock on the door of a banker, maybe somebody will open the door because they have a piece of paper in their hand."

Now, Madam Chair, this program has not been a windfall. It has not been a rip-off. There have been 300 transactions in nearly 20 years. The overwhelming majority of those 300 transactions have been radio transactions, small radio transactions.

The overwhelming majority of the individuals involved in those transactions are still in the business today. Now, we have——

Chairman JOHNSON. When you say the overwhelming majority of transactions, do you mean of the 15,000 or the 317?

Mr. BROWN. Of the 317 transactions. They are still in business today. Some of them have traded up in terms of the number of stations, but they are still in the business today.

Then, Madam Chair, we look at the big transaction that gets all of the press coverage. Well, that transaction is an aberration in terms of the pattern that we have seen under this policy. But beyond that, I would bet the family jewels that this transaction would never have resulted in a $280 to $400 million tax. The transaction would have been done with somebody else, it would have been done as a merger, it would have been done as a tax-free reorganization, it might not have been done, it might have been done as a swap. But the fact of the matter is that the transaction would not have occurred with tax consequences on the order of $300 to $400 million.

Madam Chair, the Treasury was never going to get that money. This is not a loss to the Treasury. What happened here is what happens in any transaction. You consider all of the factors that go into deciding whether you are going to dispose of property, when you are going to dispose of it, what kind of liabilities you are going to pick up, what kind of liabilities you are going to pass to other people; if you are a public company, you consider what impact the transaction will have on your stock and your shareholders, what you are going to do with the cash. You look at all those factors and you decide this is the way I am going to do the deal.

You change one of the major factors, like the tax consequences, you do it a different way or you do not do it. Four hundred million dollars? Nobody dislikes money. Nobody is going to give it to the Treasury if they can find a way not to do it.

Madam Chair, I will stop at this point and submit my written testimony for the record.

[The prepared statement follows:]

STATEMENT OF TYRONE BROWN, ESQ.,
ON BEHALF OF BLACK ENTERTAINMENT TELEVISION, RADIO ONE, INC., AND THE SYNCOM FUNDS

1. Statement of Interest, Summary of Position.

Madam Chairperson, Members of the Subcommittee:

My name is Tyrone Brown. I am submitting this Statement for myself and on behalf of Black Entertainment Television, Radio One, Inc., and The Syncom Funds.

I am an attorney engaged in telecommunications practice with the Washington, D.C. law firm of Wiley, Rein & Fielding. From 1977 to 1981, I served as a Commissioner of the Federal Communications Commission.

Prior to my tenure at the FCC, I was Vice President, Legal Affairs of Post-Newsweek Stations, Inc., the broadcast subsidiary of the Washington Post Company which operates television broadcast stations in a number of cities. After leaving the FCC, I helped to organize and manage District Cablevision, Inc., the cable television service provider in the District of Columbia. I have never had an interest in any transaction involving the issuance of a tax certificate under section 1071 of the Internal Revenue Code.

Since 1978, and beginning during my tenure as a Commissioner, the FCC, acting under section 1071, has issued a "tax certificate" (entitling the recipient to a deferral of taxable gain) to any taxpayer desiring such a certificate who sells a radio or television station, or a cable television system, to a minority individual or a minority-controlled firm. The purpose of this hearing is to assess the FCC's legislative authority to issue tax certificates in these circumstances, and to assess the effectiveness and appropriateness of the FCC's approach in fostering the goal of increased minority ownership of broadcast and cable television outlets.

Madam Chairperson, I respectfully submit that both the FCC's interpretation of section 1071 and its authority to issue minority ownership tax certificates are well established under current law. The FCC's interpretation and its authority have been repeatedly confirmed in appropriations legislation enacted by the Congress annually since 1988.

Of course, Madam Chairperson, this Subcommittee may initiate changes in the law. I respectfully urge the Subcommittee not to recommend dismantlement of the minority ownership tax certificate program. The FCC, through two Republican and two Democratic Administrations, has painstakingly developed this program, and it works. I would request that, based upon input from the FCC and interested parties, the Subcommittee report only such prospective changes, if any, as it concludes will make more effective the FCC's administration of minority ownership tax certificates under section 1071.

The FCC's program has led directly to a five-fold increase in minority ownership of radio and television broadcast stations, and to an increase in minority ownership of cable television systems as well. Elimination of this initiative would signal that increased minority ownership of electronic media of mass communications no longer is a priority with the Congress. This would be a wholly inappropriate message. Even with the tax certificate, minorities today control no more than three percent of the nation's broadcast outlets, and fewer still of its cable television systems.

2. **The FCC's Tax Certificate Policy Effectively and Appropriately Furthers the Goal of Minority Ownership.**

Madam Chairperson, I stated that minorities today own approximately three percent of the nation's broadcast stations. In 1978 when the FCC adopted its initial Statement of Policy on Minority Ownership, minority ownership was not much more than one-half of one percent.

In the light of the impact that the broadcast and cable technologies have on all the diverse, smaller communities that make up our national community, in my capacity as an FCC Commissioner I considered the minority ownership situation that existed in 1978 to be unacceptable. Frankly, Madam Chairperson, I consider the minority ownership situation that exists today to be not much better. However, it is better. And, I am convinced that the little

improvement that has occurred is in large part attributable to the availability of the minority ownership tax certificate.

In making the tax certificate the centerpiece of its initial effort to achieve greater minority ownership in broadcasting and, later, in cable television, the FCC adopted a device that is precisely tailored to overcome, to some to a degree, the two missing ingredients that typically frustrate the minority entprepreneur's attempt to become involved as an owner of a broadcasting or cable television outlet. These two missing ingredients are, first, lack of information and, secondly, lack of access to capital.

Madam Chairperson, quite simply, the tax certificate converts the minority entrepreneur into someone whom a prospective seller may want to talk with, and into someone who will not necessarily confront only closed doors when he or she ventures into the capital markets.

The certificate does not confer wealth upon the minority entrepreneurs through a reduction in selling price. Nor does it deny the Treasury a tax, since taxes are merely deferred and not reduced or eliminated. On the other hand, economic activity is stimulated through the retention of funds in gainful private sector activity.

This is what the tax certificate secures for the minority entrepreneur, and it is all that it secures for him or her. But the open door, and that access to the prospective supplier of capital, may be (after his or her own dogged determination) the minority entrepreneurs's most important asset.

Madam Chairperson, it is for this reason that I strongly urge the Subcommittee to support continued availability of the minority ownership tax certificate under section 1071.

3. The FCC Possesses Explicit Authority To Issue Minority Ownership Tax Certificates.

Madam Chairperson, because the Subcommittee has raised a number of questions about the FCC's current authority to issue minority ownership tax certificates, I also feel the need to address this issue of legislative authorization.

There have been suggestions that the FCC, in the 1978 Statement of Policy, abruptly and impermissibly altered its prior interpretation of section 1071 of the Internal Revenue Code. The implication is that prior to 1978 the FCC issued a tax certificate only when the taxpayer was compelled to dispose of broadcast property due to new agency policy, but in announcing the minority ownership policy the Commission for the first time extended section 1071 treatment to voluntary dispositions.

Madam Chairperson, I want to assure the Subcommittee that adoption of the tax certificate policy in 1978 did not involve any expansion of the Commission's interpretation of section 1071. As we specifically stated in the 1978 Policy Statement, under preexisting agency practice the FCC had routinely issued tax certificates in connection with certain voluntary dispositions of broadcast properties that furthered agency policy.

In any event, Madam Chairperson, if doubts once existed about the FCC's authority to issue tax certificates in connection with transfers of broadcast and cable outlets to minorities under current law, those doubts now have been resolved in favor of such authority.

In each fiscal year since 1988, the FCC appropriations legislation has not only expressly acknowledged the existence of the Commission's minority ownership tax certificate policy, but it has also expressly forbidden use of appropriated funds to repeal or retroactively change that policy. The fiscal 1995 legislation, for example, states that appropriated funds may not be used to repeal or retroactively change the FCC's minority ownership initiatives, "including those established in the Statement of Policy on Minority Ownership of Broadcasting Facilities . . . ."

Under the circumstances, Congressional endorsement of the FCC's interpretation of its authority under section 1071 could hardly be more clear.

4. The FCC's Minority Ownership Policies Have Evolved in a Spirit of Bipartisanship and Cooperation.

Madam Chairperson, the FCC has never treated its minority ownership policies as static rules that are good for all circumstances or for all time.

The original tax certificate policy was an initial response that grew out of a first conference on minority ownership sponsored by the FCC in 1977 under the leadership of Richard Wiley who chaired the Commission during the Nixon and Ford Administrations.

Extension of the tax certificate policy to sales of cable television systems occurred in 1982 under President Reagan's Chairman Mark Fowler, as a result of recommendations from an Advisory Committee headed by then-Commissioner Henry Rivera.

Most recently, Congress' enactment of spectrum auction legislation, and its mandate to the FCC to assure opportunities for minority ownership participation in the auctioned spectrum (as well as ownership participation by female-controlled firms and small businesses) has required the Commission to undertake what is perhaps its most comprehensive reexamination of its minority ownership policies to date.

Hopefully, this process of re-examination and refinement will continue. In that process this Subcommittee has an appropriate oversight role to assure that section 1071 is not abused.

5. Conclusion.

Madam Chairperson, members of the Subcommittee, in closing I wish to reemphasize that I, as well as Black Entertainment Television, Radio One, Inc., and The Syncom Funds, strongly urge the Subcommittee to support the continued availability of the minority ownership tax certificate under section 1071.

Thank you for this opportunity to share my views in this very important area.

Chairman JOHNSON. I appreciate your comments. It does appear we still need a record. We still need to know what in fact——

Mr. BROWN. I would agree with that.

Chairman JOHNSON. Who has had ownership. The fact we have none of that, does matter. But I hope it is as you say.

Mr. BROWN. I would be glad to include in the record a list of all of the companies that have received tax certificates.

Chairman JOHNSON. That would be interesting.

Mr. BROWN. Since the inception of the program, because I have it available and will be glad to do that.

Chairman JOHNSON. If you know all the principals in those companies, that would be useful, too.

Mr. BROWN. I am not sure I do, but to the extent I can.

Chairman JOHNSON. Because the government has a hard time coming up with that information. Any information you can give us along that line is helpful.

[The following was subsequently received:]

Summary of Tax Certificate Data (as of 2/2/95)

Before 1978, minorities owned approximately one half of one percent (40) of the approximately 8,500 total broadcast licenses issued by the FCC. In fact, the National Association of Black Owned Broadcasters (NABOB) reports that approximately 2 to 3 minority broadcast transactions were consummated each year prior to the implementation of the FCC minority tax certificate policy in 1978. Today, a 1994 study performed by the National Telecommunication and Information Administration at the Department of Commerce, indicates that there are approximately 323 radio and television stations owned by minorities, 2.9% of the total 11,128 licenses held in 1994. This represents a 700% increase in the number of licenses issued to minorities since the application of section 1071 to minority owned broadcast and cable properties (15 years).

Industry Total	Black	Hispanic	Asian	Native American	Minority Totals
AM Stations 4,929	101 (2%)	76 (1.5%)	1 (0%)	2 (0%)	180 (3.7%)
FM Stations 5,044	71 (1.4%)	35 (.7%)	3 (.1%)	3 (.1%)	112 (2.2%)
TV Stations 1,155	21 (1.8%)	9 (.8%)	1 (.1%)	0 (0%)	31 (2.7%)
Cumulative Totals 11,128	**193(1.7%)**	**120(1.1%)**	**5(0%)**	**5(0%)**	**323 (2.9%)**

Of the total number of licenses currently held by minorities the data available indicates that up to 30% of the radio stations were acquired with the use of a tax certificate and up to 90% of the television stations were acquired with the use of a tax certificate. Data is unavailable for cable. Also, NABOB reports that the vast majority of existing minority broadcast owners have utilized tax certificates during the past 15 years either: 1) as an incentive to attract initial investors; 2) to purchase a broadcast property; or 3) to sell a broadcast property to another minority.

During the past 15 years, the issuance of minority tax certificates has resulted in the sale or transfer of over 260 radio licenses, 40 television licenses and 30 cable licenses, totalling approximately 330 tax certificates issued for minority deals. In contrast, approximately 117 non-minority tax certificates have been issued during the life of Section 1071.

Type of License	Certificates Issued	of Total
Minority Radio	260	58%
Minority TV	40	9%
Minority Cable	30	7%
Non-minority	117	26%
Total	447	100%

There was a significant increase in the number of minority tax certificates issued between the years 1987 and 1989. This increase corresponds with the robust trading experienced by the broadcast and cable industry during this period. The level of tax certificate activity also declined significantly in 1991 when federal restraints were placed on highly leveraged transactions and access to capital became a problem for the industry as a whole.

Year	Certificates Issued	of Total
1978	4	1%
1979	12	4%
1980	10	3%
1981	15	5%
1982	15	5%
1983	10	3%
1984	11	3%
1985	17	5%
1986	18	5%
1987	33	10%
1988	33	10%
1989	45	14%
1990	46	14%
1991	18	5%
1992	14	4%
1993	21	6%
1994	8	2%
Total	330	100%

Diversity of Ownership:

Ownership data is available for approximately 55% (142) of the tax certificates issued in minority radio transactions. From this sample, there are approximately 77 separate owners (54%) of radio properties listed. Ownership data is available for approximately 98% (39) of the tax certificates in television transactions. From this sample there are approximately 21 (54%) separate owners listed. Ownership data is available for all 40 of the tax certificates issued in cable television transactions. From this listing, there are 20 (66%) separate owners of cable properties. In sum, the data indicates that well over half of

the broadcast and cable properties receiving tax certificates are owned by different individuals or companies.

The racial allocation of the minority tax certificates are as follows:

African Americans	64%
Hispanics	23%
Native American	1%
Alaskan Native	4%
Asian	8%

Holding Period:

Although FCC regulations require the buyer of a property for which a tax certificate is issued to hold that station for one year, the overwhelming majority of minority buyers retain their licenses for much longer. Example, of the total certificates issued, minority buyers of radio and television properties have held their licenses for an average of 5 years. Cable is excluded from these figures because there is insufficient data available on the holding period. However, the Communication Act requires that all cable systems be held for a minimum of three years following either the acquisition or initial construction of such system. Holding period information is available for approximately 83% of the minority radio stations and all of the minority television stations.

Size of Transactions:

After reviewing a sample consisting of 55% of radio stations and 78% of television stations, the data indicates that the great majority of the sales transactions in which tax certificates are awarded are relatively small, averaging a sales price of $3.5 million for radio stations and $38 million for television stations. Data is not available for the 30 cable deals, although we know that cable deals tend to be larger transactions.

FCC has no data available on the amount of tax gains actually deferred.

Other Findings:

Although the tax certificate program is not the only FCC program designed to encourage transfer of licenses to minorities, it is the most frequently used program and is often used in concert with the other programs. In addition, various entrepreneurs and industry associations have submitted testimony to FCC which indicates that: "But for the tax certificate program the acquisition of existing broadcast and cable properties by minorities would be significantly more difficult to consummate."

[Tax Certificate chart retained in Committee files.]

Chairman JOHNSON. Mr. Alarcon.

STATEMENT OF RAUL ALARCON, JR., PRESIDENT AND CHIEF EXECUTIVE OFFICER, SPANISH BROADCASTING SYSTEM, INC.

Mr. ALARCON. Good afternoon, Madam Chairwoman, members of the Oversight Subcommittee. My name is Raul Alarcon, Jr., president and chief executive officer of the Spanish Broadcasting System. I thank you for the opportunity of addressing you here today.

In your hearing announcement you stated that these hearings would examine, among other things, whether the tax incentive provided in section 1071 of the Internal Revenue Code, in fact, fosters minority ownership of broadcast facilities. It is precisely this question that I wish to address today. Let me state at the outset that the tax certificate program, in my opinion, is a tremendously valid and beneficial policy and a tribute to the Congress that mandated it and to the FCC that implements it.

Let me tell you a little about the Spanish Broadcasting System. SBS is a family-owned and operated radio company founded in 1983. My father, one of the founders, was born in Cuba, as I was, where he owned a chain of radio stations that were seized by the Castro government in 1960. We emigrated to the United States with very few possessions and became U.S. citizens. For 20 years my father worked his way up in the Spanish language radio and, for him, the purchase of our first station in 1983 represented the fulfillment of his dream to return to the business of owning and operating broadcast stations.

Our first station was a small AM station licensed in Newark, N.J. The owners of SBS, who are all Hispanic, mortgaged everything they had to start this station. However, we would never have emerged from the starting gate if not for the government's tax certificate program. The tax certificate policy encourages sellers to take the risk of selling to small, less well-known companies and allows minority-controlled entities to gain a foothold in an industry that is dominated by historically established major media corporations.

Today, 12 years after we purchased our first station, we are the largest Hispanic-owned media company in the United States. We operate 7 radio stations in the major markets—New York City, Los Angeles, and Miami. Each of these stations provides Spanish language programming and public service that is targeted to the community it serves. WSKQ FM, our New York FM, is in fact the only Spanish language FM station in New York City.

I am proud to say that our stations are public service oriented and financially successful. We own the No. 1-rated radio station in Los Angeles, Calif., surpassing all other English and Spanish language competitors. We are the fifth-rated radio station in the highly competitive New York market, making us the first foreign language station to break into the top 10 in the history of New York City audience ratings.

The FCC's tax certificate policy made all this possible. Without the tax certificate, it is highly questionable whether any of the sellers would have sold their stations to SBS. Each of the SBS stations was purchased under the issuance of a tax certificate. We believe

that the company itself, SBS, is proof of the success of the tax certificate policy.

The fact of the matter is that it is hard for anyone to break into the broadcast industry. Many of the barriers to entry are created by the simple fact that the radio spectrum is limited and broadcast licenses are a scarce and highly valued commodity, especially in the major markets where Hispanic listeners are concentrated. Available stations are getting harder to find, particularly for the minority buyer. The FCC's decision to relax the duopoly ownership rules has created a new group of in-market buyers, in effect, foreclosing many opportunities for minorities in the future.

The tax certificate policy is the least intrusive way for the government to accomplish the goal of increasing minority ownership of broadcast stations. It involves no government loans, no government loan guarantees, no set-asides, and no government mandates, nor is it a giveaway. It is, as many commentators have observed, a deferral—a deferral—not a waiver of tax. It works. The advantages offered by the tax certificate make it possible for minority buyers to compete for and purchase broadcast stations.

Let me dispel a common myth. There is an assumption that the tax certificate allows minority buyers to purchase stations at a discount. This has not been my experience. Spanish broadcasting has paid market prices for its stations. But without the ability to defer the gain on a sale, many station owners would not sell their stations at all, let alone to a minority buyer with limited resources.

What difference does Hispanic ownership make? As broadcasters, we believe it makes a big difference. I have heard people say Hispanic ownership is of no real consequence. If this is true, why was there no Spanish language FM station in New York before we inaugurated WSKQ FM 5 years ago? Similarly, why were Asians the first to establish Asian language stations? Why were African-American broadcasters pioneers in introducing the urban format in major cities?

The fact is we care about the communities we serve. I have heard complaints about minorities buyers making quick sales following tax certificate transactions. In 12 years of operations, we have never sold a station. We are invested in this business, committed to the business, and committed to the communities we serve.

During the gulf war, during Hurricane Andrew, the California earthquake, and the civil disturbances in Los Angeles, we provided news and information in Spanish to our communities in New York, Florida, and California. These broadcasts included information regarding emergency relief services and fundraising efforts on behalf of thousands of victims in need of assistance. No mainstream broadcasters speak to this community in the way we do, nor, in my view, are they capable of doing so.

Also, we provide jobs, new jobs, both for on-air as well as administrative personnel. We provide market opportunities and revenues for the businesses that advertise on SBS radio stations, and we showcase talent that would not otherwise receive air play or recognition.

I have one more paragraph, Madam Chair.

Chairman JOHNSON. OK.

Mr. ALARCON. As I have said, the tax certificate program made all of this possible. In our opinion, an opinion that is shared by millions of Spanish radio listeners, the tax certificate program works and works well. It should be retained.

Indeed, if we are to measure the effectiveness of government programs by the many social benefits they engender, then the tax certificate program should not only be retained, but other even more far-reaching and innovative measures to encourage minority ownership in the media should be investigated and implemented.

Thank you, Madam Chair.

[The prepared statement follows:]

STATEMENT OF RAUL ALARCON, JR.
PRESIDENT AND CHIEF EXECUTIVE OFFICER
SPANISH BROADCASTING SYSTEM, INC.
before the
Subcommittee on Oversight
Committee on Ways & Means
United States House of Representatives
Washington, D.C.
January 27, 1995

Madame Chairman and Members of the Oversight Subcommittee. My name is Raul Alarcon, Jr. I am the President and Chief Executive Officer of Spanish Broadcasting System, Inc. I am pleased to have this opportunity to testify before the Subcommittee concerning the government's policy of issuing tax certificates on the sale of certain telecommunications facilities. This program has several purposes, one of which is to encourage the sale of telecommunications properties to minority owned or controlled companies.

In your hearing announcement, you stated that these hearings would examine, among other things, "whether the tax incentive provided in section 1071 [of the Internal Revenue Code] in fact fosters minority ownership of broadcast facilities." It is this question that I wish to address today.

Let me begin by telling you something about Spanish Broadcasting System. SBS is a family-owned and operated radio company, founded in 1983. My father, one of the founders, was born in Cuba, as I was. In Cuba, he owned a chain of radio stations that were seized by the Castro government. We emigrated to the United States with very few possessions. We became United States citizens, and for twenty years my father worked his way up in Spanish language radio, working jobs in programming, sales, and advertising. For him, the purchase of our first station in 1983 represented the fulfillment of his dream to return to the business of owning and operating broadcast stations.

Our first station was a small, AM station licensed to Newark, New Jersey. This station was the first Spanish-language station introduced into the New York/New Jersey radio market in more than a quarter century. The owners of SBS, who are all Hispanic, mortgaged everything they had to start this station. However, we would never have emerged from the starting gate if not for the government's tax certificate program. The tax certificate policy encourages sellers to take the risk of selling to small, less well-known companies, and allows minority controlled companies to gain a foothold in an industry that is dominated by successful, established, and well-financed companies.

Twelve years after we purchased our first station, we are the largest Hispanic-owned media company in the United States. We operate seven radio stations in major markets: WSKQ-AM and FM serving New York, KXED-AM and KLAX-FM in Los Angeles, WCMQ-AM and FM serving Miami, and WZMQ in Key Largo. Each of these stations provides Spanish language programming and public service that is targeted to the community it serves. WSKQ-FM is, in fact, the only Spanish-language FM station in New York City.

I am proud to say that our stations are public service oriented and financially successful. We own the number-one rated radio station in Los Angeles, California, beating out all other English and Spanish-language competitors. We are the fifth-rated radio station in the highly competitive New York market, making us the first foreign language station to break into the Top Ten in the history of New York City audience ratings.

The FCC's tax certificate policy made this possible. Without the tax certificate policy, it is highly questionable whether any of the sellers would have sold their stations to SBS. Each of the SBS stations was purchased under a tax certificate -- and we believe that SBS is proof of the success of that policy.

In 1978, when the FCC announced that it would use its authority to grant tax certificates as a means of encouraging minority ownership of broadcast facilities, the Commission observed that "diversification in the areas of programming and ownership ... can

be more fully developed through ... encouragement of minority ownership of broadcast properties."[1]

We recognize that this policy has been controversial. Yet even its most vociferous critics have cited Spanish Broadcasting as one of the program's success stories. It is important to keep in mind, therefore, that this success is a direct result of the tax certificate policy. The tax certificate made it possible for us to buy each station we own -- and made it possible for us to offer Spanish language programming that serves America's large and growing Hispanic community. In the case of each purchase, the seller has made the issuance of a tax certificate a condition of the sale.

The fact of the matter is that it is hard for anyone to break into the broadcast industry. Many of the barriers to entry are created by the simple fact that the radio spectrum is limited -- and broadcast licenses are a scarce and highly valued commodity. Barriers to entry are especially high in the major markets where Hispanic listeners are concentrated. Competition is keen. Stations in the Top Ten radio markets range in price from $40 million to $150 million.

Available stations are getting harder to find, particularly for the minority buyer. The FCC's decision to relax the duopoly ownership rules has made it possible for broadcasters to buy second, third, and fourth stations in markets that were previously closed to them -- thereby creating a new group of buyers -- and foreclosing many opportunities for minorities. In this environment, Blacks, Hispanics, and other minorities that have historically lacked access to capital markets are now faced with even more limited opportunities to acquire and operate radio stations, and -- in many cases -- are forced to bid against media giants with vast resources.

The tax certificate policy is the least intrusive way for the government to accomplish the goal of increasing minority ownership of broadcast stations. It involves no government loans, no government loan guarantees, no setasides, and no government mandates. Nor is it a giveaway. It is, as many commentators have observed, a deferral -- not a waiver -- of tax. And it works. The advantages offered by the tax certificate make it possible for minority buyers to compete for and buy broadcast stations.

The tax benefit goes to the seller -- not to the minority buyer. And let me dispel one common myth. There is an assumption that the tax certificate allows minority buyers to buy stations at a discount. This has not been my experience. Spanish Broadcasting has paid market price for its stations -- but it was the tax certificate that made the deal possible. Without the ability to defer the gain on a sale, I know from experience that many station owners would not sell their stations at all -- let alone to a minority buyer with limited resources.

What difference does Hispanic ownership make? As broadcasters, we believe it makes a big difference. I have heard people say that Hispanic ownership is of no real consequence -- that any smart broadcaster will program to the Hispanic market. If this is true, why was there no Spanish-language FM station in New York before we started WSKQ-FM five years ago? Similarly, why did it take Asians to establish the first Asian language stations? Why are some of the highest-rated urban formatted stations owned by Black broadcasters?

The fact is -- we care about the communities we serve. I have heard complaints about minority buyers making quick sales following tax certificate deals. In 12 years of operation, we have never sold a station. We are invested in this business, committed to it and to the communities we serve. The tax certificates have made it possible for SBS -- a 100% Hispanic-owned company -- to address the needs, interests, and problems of the Hispanic community.

During the Gulf War, during Hurricane Andrew, during the California earthquake and the civil disturbances in Los Angeles, we provided news and information -- news of special interest to the Hispanic communities -- in New York, Florida, and

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[1] Statement of Policy on Minority Ownership of Broadcasting Facilities, May 25, 1978, FCC 78-322, at 4.

California. Our AM stations have morning news blocks dedicated to news and local affairs. We sponsor community events. We are involved in the fabric of the community and its neighborhoods, and our numerous public service awards attest to our standing in the community. No mainstream broadcasters speak to this community in the way that we do, nor -- in our view -- are they capable of doing so.

We provide jobs -- new jobs -- both for "on-air" as well as administrative personnel. We provide market opportunities and revenues for the businesses that advertise on SBS radio stations. We provide a showcase for talent that would not otherwise receive airplay or recognition. If other, mainstream stations are now discovering Hispanic markets and Hispanic programming, it is because we pointed the way -- and continue to lead. In 1983, when we purchased our first station, there were fewer than 100 Spanish-language radio stations in the United States. Today, there are more than 300 Spanish-language formatted stations.

The tax certificate program, like all programs, has its failures and its successes. SBS is a success story. There are others. We can only speak from our experience, but -- in our view -- doing away with the tax certificate program, as some have suggested, would be short-sighted -- and offers no real guarantees of new tax revenues.

First, as noted, the tax certificate program only permits a deferral of tax -- not a waiver. Second, it cannot be assumed that, but for the tax certificate program, each and every sale to a minority owner would have generated tax revenues in the year of the sale. Many sales would never happen in the first place. Many owners would not sell their properties at all if they couldn't defer the taxes -- or they would search for other tax-favored ways to sell their properties.

Finally, to the extent minority owners have turned stagnant properties into money-making ventures, created jobs, and opened new markets, the tax certificate program has generated taxes -- and keeps doing so, year in and year out. The tax certificates facilitate such new investment, and bring new ideas and new voices to the broadcast community, a community that must be -- by definition -- a reflection of America's pluralistic society.

The tax certificate program made it possible for us to buy our first radio station. It enabled us to grow from one small station to become the largest Hispanic media company in the nation -- and a market leader in the largest radio markets in the United States. We are proud of our accomplishments -- and we are proud of our record of service to the community.

In our opinion, an opinion that is shared by millions of Spanish radio listeners, the tax certificate program works and works well. It should be retained. Indeed, if we are to measure the effectiveness of government programs by the many social benefits they engender, then the tax certificate program should not only be retained, but other, even more far-reaching and innovative measures to encourage minority ownership of the media should be investigated and implemented.

We thank you for this opportunity to present our views.

Chairman JOHNSON. Thank you very much.
Ms. Sutter.

STATEMENT OF DIANE SUTTER, PRESIDENT, SHAMROCK TELEVISION, BURBANK, CALIF., ON BEHALF OF AMERICAN WOMEN IN RADIO AND TELEVISION, INC.

Ms. SUTTER. Thank you. Good afternoon Chairperson Johnson and members of the subcommittee. I am Diane Sutter, president of Shamrock Television and past national president of American Women in Radio and Television. Shamrock Television and Shamrock Broadcasting operate radio and televisions stations in the United States and are seeking to acquire additional stations.

I appear before this subcommittee today on behalf of AWRT, and to express AWRT's strong support for the use of tax certificates by the FCC to increase minority ownership of broadcast and other mass media properties. Since our testimony has been filed with this subcommittee, I will summarize it.

AWRT is a nonprofit national organization of professional men and women working in the electronic media.

Chairman JOHNSON. You don't have to feel rushed. You do have your 5 minutes.

Ms. SUTTER. Thank you. The mission of AWRT is to enhance the impact of women in the electronic media. AWRT strongly supports the policies to promote the ownership of broadcast and other communications properties by women and minorities, including the FCC's award of tax certificates pursuant to section 1071 to increase minority ownership.

Consistent with the underlying intent of section 1071, tax certificates have proven to be a valuable incentive that furthers the FCC's policy of increasing ownership of broadcast stations and cable properties by qualified minorities. AWRT also supports the extension of the FCC's tax certificate policy to include the availability of section 1071 certificates to investors and qualified women-owned companies to advance diversity which does not now exist.

Based on my experience in the broadcast industry, I can tell you firsthand that the availability of tax certificates can be a pivotal factor in evaluating a broadcast sale or an investment.

AWRT supports rigorous review by the FCC of the eligibility of companies for tax certificates. The potential for abuse should not be used as a basis to eliminate an appropriate and effective market-based incentive for increasing minority ownership of broadcast stations and an incentive that could appropriately be used to increase ownership of broadcast stations and other mass media facilities by women.

As you have heard, and will hear today, the use of tax certificates has directly buttressed the FCC's important goal of increasing minority ownership and diversity of broadcast and cable facilities. Tax certificates have added the value of stimulating investment in mass media properties by minority-owned companies.

By requiring the recipient of a tax certificate to reinvest the sale proceeds in a qualified property, the awarding of 1071 stimulates economic growth, specifically 1071's requirement of investing the proceeds in a qualified replacement properties to defer tax investments not to eliminate them.

Tax certificates also provide a direct market-based incentive for investment in minority-owned companies. Market-based incentives that increase access to capital are essential to redressing the underrepresentation of minorities and women in the broadcast industry.

Statistics on women-owned businesses demonstrate the continued barriers that women face in raising capital required to acquire broadcast and cable properties. The discrimination that exists against women entrepreneurs has been recognized by Congress. Congress' recognition of the barriers faced by women in obtaining financing for business ventures, as well as in statistics included in our testimony on the low level of representation of women ownership in broadcast stations, fully supports the extension of the FCC's policy of awarding 1071 tax certificates to qualified women-owned companies seeking to acquire broadcast and cable facilities to provide incentives for women ownership of broadcast and cable properties.

The statistics demonstrate what Congress clearly recognized when it enacted the Omnibus Budget Reconciliation Act of 1993, and in the order to the FCC to use spectrum auctions to award licenses for the commercial mobile radio services; that the dissemination of spectrum licenses among a wide variety of applicants, including businesses owned by women, is an important and legitimate government interest.

The same congressional concern about underrepresentation by women, and the provision of spectrum-based services that resulted in that congressional mandate, warrants the use of section 1071 tax certificates as an incentive to increase female ownership of broadcast and cable facilities.

AWRT has encouraged the FCC to conduct a survey and study the current level of women ownership of broadcast facilities. The FCC has not conducted such a survey since 1982. Such a study would enable the FCC and Congress to identify the trends in broadcast ownership and provide an important foundation for future policy decisions.

We would like to work with this subcommittee and to supplement our testimony by providing additional written comments in relation to things we have heard today, and we encourage the subcommittee to look for ways in which we can increase the diversity which we believe minority certificates have brought to the picture by including women.

[The prepared statement follows:]

TESTIMONY OF DIANE SUTTER
ON BEHALF OF
AMERICAN WOMEN IN RADIO AND TELEVISION, INC.
BEFORE THE
HOUSE WAY AND MEANS COMMITTEE
SUBCOMMITTEE ON OVERSIGHT

JANUARY 27, 1995

Good morning, Chairwoman Johnson and members of the Subcommittee. I am Diane Sutter, President of Shamrock Television and past national president of American Women in Radio and Television, Inc. ("AWRT"). Shamrock Television is the owner of a small market network television station. Shamrock also is actively engaged in seeking to acquire additional small and medium market television stations. Shamrock Broadcasting, Inc., our affiliate, owns 18 major market radio stations. It is an honor for me to appear before this Subcommittee today on behalf of AWRT and to express AWRT's strong support for the use of tax certificates by the FCC to increase minority ownership of broadcast and other mass media properties.

AWRT is a non-profit, national organization of professional women and men who work in radio, television, cable, advertising -- essentially the electronic media -- and closely allied fields. The mission of AWRT is to enhance the impact of women in the electronic media and allied fields by educating, advocating, and acting as a resource to its members and the industry. AWRT strongly supports appropriate policies to promote the ownership of broadcast and other communications properties by women and minorities. AWRT believes that the FCC's award of tax certificates pursuant to Section 1071 to increase minority ownership of broadcast and cable properties is an example of just such an appropriate market-based policy. Consistent with the underlying intent of Section 1071, tax certificates have proven to be a valuable incentive that furthers the FCC's policy of increasing ownership of broadcast stations and cable properties by qualified minorities. AWRT also supports the extension of the FCC's tax certificate policy to include the availability of Section 1071 certificates to investors in qualified women-owned companies seeking to acquire broadcast and cable properties and to companies that sell their existing broadcast and cable properties to qualified women-owned companies.

Since adoption of the FCC's policy to award tax certificates to increase minority ownership of broadcast properties in 1978, tax certificates have proven to be one of the most valuable financial incentives in broadcast acquisitions. As of October 1994, 283 tax certificates have been awarded by the FCC for broadcast stations while 25 have been issued for cable sales. Based on my experience in the broadcast industry, I can tell you first hand that the availability of tax certificates can be a pivotal factor in evaluating a broadcast sale or investment.

To ensure the appropriate use of Section 1071 certificates, AWRT supports rigorous review by the FCC of the eligibility of companies for tax certificates. Stringent case-by-case review of the ownership and qualifications of a company on which an application for a tax certificate is based can be conducted by the FCC to weed out any potential abuses of the FCC's tax certificate policy. The general, unsubstantiated fear of such abuses should not be used as a basis to eliminate an appropriate and effective market-based incentive for increasing minority ownership of broadcast stations and an incentive that could be appropriately used to increase ownership of broadcast stations and other mass media facilities by women.

Past studies have shown that the use of tax certificates has directly buttressed the FCC's important goal of increasing minority ownership of broadcast and cable facilities. Tax certificates have the added value of stimulating investment in mass media properties and minority-owned companies. By requiring the recipient of a tax certificate to reinvest the sale proceeds in "qualified replacement property," the awarding of Section 1071 tax certificates stimulates economic growth. Specifically, Section 1071's requirement of reinvesting the proceeds of the tax certificate in "qualified replacement property" to defer taxation fuels

additional investment by the seller. This investment, rather than the mere pocketing of the sale proceeds, stimulates additional economic growth in the form of economic expansion, additional job growth and the creation of new and greater market opportunities. Tax revenues also are derived even if the investor who receives a tax certificate elects to reinvest the proceeds of the tax certificates in other existing media properties rather than new properties because the investment in the existing property will trigger a taxable sale of that existing property.

The tax revenues gained from the multiplier effect of this additional investment and the continued operation of the broadcast and cable properties by minority-owned companies may well offset the revenue losses from deferral of taxation permitted by the award of a Section 1071 tax certificate. In addition, award of a Section 1071 certificate merely permits deferral of the tax. The tax ultimately will be realized upon the sale of the replacement property.

Tax certificates also provide a direct market-based incentive for investment in minority-owned companies. Initial investors in minority-owned companies are eligible for a Section 1071 certificate on the sale of their interests. Market-based incentives that increase access to capital are essential to redressing the under-representation of minorities and women in the broadcast industry. Statistics on women-owned businesses demonstrate the continued barriers that women face in raising the capital required to acquire broadcast and cable properties. The discrimination that exists against women entrepreneurs has been recognized by Congress. Seven years ago, due in large part to the leadership of women in Congress, Congress enacted the Women's Business Ownership Act of 1988. In 1992, Congress again sought to redress the hurdles that women and minorities face in raising capital by enacting the Small Business Credit and Business Opportunity Enhancement Act of 1992. Congress' recognition of the barriers faced by women in obtaining financing for business ventures as well as statistics on the low level of representation of women in ownership of broadcast stations fully support extension of the FCC's policy of awarding Section 1071 tax certificates to qualified women-owned companies seeking to acquire broadcast and cable facilities and to provide incentives for women-ownership of broadcast and cable properties.

Thirty-two percent (32%) of all small businesses were owned by women in 1991 according to the U.S. Small Business Administration.[1/] Despite these encouraging general statistics, this business growth has not been mirrored or even suggested in the broadcast industry. In 1987, the latest year for which relevant statistics currently are available, only 26 television stations were owned and controlled by women out of 1,342 television stations operating in the United States.[2/] In other words, in 1987 only 1.9% of all television stations were owned and controlled by women. Out of the 10,244 radio stations operating in the United States at that time, only 394, or 3.8% of all radio stations, were owned 50% or more by women.[3/] Thus, in 1987, only 420 out of a total of 11,586 broadcast stations were owned and controlled by women.

Other studies confirm the low level of representation of women in the ownership ranks of broadcast facilities. A Congressional Research Service Study entitled "Minority Broadcast Station Ownership and Broadcast Programming: Is There a Nexus?," released in 1988, found that women held a 51% or greater ownership interest in 7.1% of the broadcast stations surveyed. A study commissioned by the FCC in 1982 found that women held 50% or more of the stock of the licensees of 8.5% of the AM stations, 9% of the FM stations and 2.8% of the television stations across the country. Although the 1982 study and the 1988

1/ *See Women Business Owners*, Congressional Caucus on Women's Issues (1992).

2/ *See Women Owned Business*, U.S. Department of Commerce (1990) (based on 1987 economic census); *see also* 1988 *Broadcasting/Cablecasting Yearbook*, p. A-2. More recent statistics on women-owned businesses are expected to be released by the Bureau of the Census in June 1995.

3/ *Id.*

Congressional Research Service study are not directly comparable because they use different definitions of control (50% and 51%), the comparison is still useful. The rough comparison reveals that women controlled 7.9% of stations in 1982 and only 7.1% in 1988 -- if not a decline, then certainly a stagnation, in the number of women-owned broadcast stations.

These numbers obviously are at odds with the number of women in the United States and in the U.S. workforce. According to the 1990 U.S. Census, women represented 46% of the civilian labor force in the United States. The FCC's latest employment statistics also indicate that women and minorities continue to be employed in the broadcasting industry at levels significantly below their representation in the overall workforce. In 1993, women constituted only 39.6% of the broadcast workforce, with 32.8% at the professional managerial level. In the cable industry, total employment of women decreased from 41.7% to 41.6, 30.9% of the professional/managerial jobs in the cable industry are held by women.[4/]

These statistics demonstrate what Congress clearly recognized when it enacted the Omnibus Budget Reconciliation Act of 1993 and authorized the FCC to use spectrum auctions to award licenses for commercial mobile radio services -- that the dissemination of spectrum licenses among a wide variety of applicants, including businesses owned by women, is an important and legitimate government interest. The same Congressional concern about under-representation by women in the provision of spectrum-based services that resulted in that Congressional mandate warrants the use of Section 1071 tax certificates as an incentive to increase female ownership of broadcast and cable facilities.

Finally, AWRT has encouraged the FCC to conduct a survey and study on the current level of women ownership of broadcast facilities. A study on female ownership of broadcast licenses has not been undertaken since the FCC's study in 1982. Such a study would enable the FCC and Congress to identify trends in broadcast ownership and provide an important foundation for future policy decisions.

AWRT looks forward to continuing to work with the Congress and this Subcommittee on issues of importance to women in the communications industry. I appreciate the opportunity to testify and would be pleased to respond to any questions.

4/ *FCC Equal Employment Opportunity Trend Report* (June 22, 1994).

Chairman JOHNSON. Thank you very much. Thank you for your input.

My colleague, Mr. Hancock, does have a question for the panel, so he has gone to vote. He will come back. If you would be so kind as to wait, he has a question, and then we will invite the other panel.

Unfortunately, I cannot return after this vote, so I will review the other testimony in writing.

I do, though, invite you all to submit, having heard the substance of the hearing, your thoughts about how this law can be improved. It clearly has some strengths, it clearly has some weaknesses. We have very little record to go on. The role of congressional oversight in this area has not been an honorable one in the last few years, and so we will be making some changes in this law, and I invite your input into those changes so that we may preserve its strengths and correct its weaknesses.

Thank you for your participation.

[The following was subsequently received:]

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Raúl Alarcón
President

By Hand

February 6, 1995

Hon. Nancy Johnson
Chairman
Subcommittee on Oversight
Committee on Ways & Means
1102 Longworth House Office Building
United States House of Representatives
Washington, D.C. 20515

Re: Section 1071
Supplement to Hearing Testimony

Dear Chairman Johnson:

As you will recall, I was privileged to testify at the Subcommittee's January 27th hearing on the Federal Communications Commission's use of Section 1071 tax certificates to increase minority ownership of broadcast facilities. This letter supplements that testimony, and I ask that a copy be included in the record to the Subcommittee's hearing.

First, during the hearing, the observation was made that tax certificate sales increased substantially in the 1980's, and some questioned the reason for this uptick. I submit that the reason for this increase was the overall health of the economy in the 1980's. During the 1980's, money was available for entrepreneurs looking for investment properties -- including minority buyers with tax certificates -- and a

substantial number of television and radio stations were bought and sold. Some were tax certificate sales, but I suspect that the number of tax certificate sales is directly related to the number of sales generally, and ebbs and flows with the market for broadcast stations.

Second, during the hearing it was noted that the Section 1071 tax certificate is not the only means by which the FCC seeks to increase minority ownership. In particular, mention was made of the FCC's distress sales policy, which allows broadcasters at risk of losing their license to sell their stations to qualified minority buyers at a price equal to 75% or less of the station's fair market value.

It is true that the FCC has used its distress sales policy to encourage sales to minority buyers -- but the distress sales policy could never substitute for the tax certificate. First, few stations are threatened with license revocation in any given year, let alone designated for a revocation hearing.* Second, of the small number, even fewer stations are available in markets with sizable minority audiences. I speak from experience.

Several years ago, on procedural grounds, I lost the chance to purchase a New York area station under the distress sale policy when the Commission, after a prolonged proceeding, decided to revoke the broadcaster's license, thereby foreclosing any distress sale. After that sale fell through, it was ten years before I again had an opportunity to buy a New York station -- at a cost of $55 Million, one of the highest prices ever paid for a New York City station. Even then, I was only able to purchase the station because I could offer the buyer the tax certificate.

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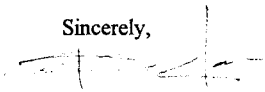
* *In his testimony before the Subcommittee, FCC General Counsel William Kennard stated that "approximately 330" tax certificate sales between 1978 and 1994 involved sales to minority-owned entities. During that same time period, according to the FCC, only 42 distress sales have been approved. In the Matter of Policies and Female Ownership of Mass Media Facilities, FCC 94-323 (Released January 12, 1995), at 4.*

Honorable Nancy Johnson
February 6, 1995

The tax certificate program has come under serious criticism in recent weeks -- and, as you suggested in statements during the hearing -- it may be appropriate for the Subcommittee to consider ways in which the policy can be made more accountable. Speaking, however, as an Hispanic-American broadcaster who has purchased every one of his stations with a tax certificate, who has never sold a station, and who has programmed every one of his stations to reach the Hispanic audience, I urge you to resist efforts to undertake wholesale repeal of Section 1071.

I am available to discuss this and other issues with you at your convenience.

Sincerely,



Raul Alarcon, Jr.

cc: Honorable Charles Rangel
Honorable Robert Masui

[Recess.]

Mr. HANCOCK [presiding]. Thank you very much for sticking around for a few minutes. I apologize, but there were a couple of questions that I had on my mind that I would like to ask, even though I was not here for all of your testimony.

Mr. Sutton, you indicated in your testimony that you had been involved in various situations involving the tax benefit of the minority enterprise. How many have you been involved in?

Mr. SUTTON. In both instances I sold to minorities to encourage others to get into the business; two instances.

Mr. HANCOCK. OK. You say in two instances.

Mr. SUTTON. Yes.

Mr. HANCOCK. Have you been involved in more than one?

Mr. WINSTON. I am the executive director of the trade association. I am not a station owner, sir.

Mr. HANCOCK. OK. Have you been involved in one?

Mr. BROWN. I have never been involved in it.

Mr. HANCOCK. OK.

Mr. ALARCON. Yes, Congressman, I have been involved in five transactions where tax certificates have been issued.

Mr. HANCOCK. OK. Here again, I apologize for asking you to wait for 10 or 15 minutes, but Mrs. Sutter, there is one question. Are you making a real good case here for capital gains for everybody?

Ms. SUTTER. Well, interestingly enough, one of the arguments for the minority tax certificate is that it can, in the same way capital gains is designed to, encourage reinvestment and the stimulation of the economy, that this serves that same purpose. So I would see the likeness to it, in that it can also be a spur to getting investment in the economy, and doing that while at the same time creating diversity, which of course capital gains does not.

Mr. HANCOCK. Well, I want to get this in as part of the record. There are people that say that capital gains only benefits the rich, and yet the situation and the case we are making here is that capital gains treatment, through tax deferment, benefits minorities pretty strongly.

This is similar to capital gains. In effect, it would apply in basically the same way, except it is earmarked as a tax benefit rather than just an across-the-board capital gains.

Ms. SUTTER. Well, it is a tax deferment subject to reinvestment in the economy.

Mr. HANCOCK. Which, in effect, is what the principle of capital gains is. It defers the taxes and that way it creates more investment and creates more economic stimulation.

Ms. SUTTER. Right. The difference with this is that it is mandated as a prerequisite to getting the tax certificate.

Mr. HANCOCK. Right. In other hearings we will be talking about capital gains and the capital gains treatment, so I just wanted to get it into the record.

Thank you very much. I appreciate it. I apologize again for keeping you here so long.

Yes, sir.

Mr. WINSTON. Mr. Hancock, may I speak to the last point you raised about the general capital gains tax reduction and how it would compare with respect to the tax certificate?

The critical point that needs to be understood about the tax certificate is that the tax certificate causes the transaction to occur to a minority. What happens is, if I am looking to sell a desirable broadcast facility, there are potential buyers lined up. Many of those potential buyers can just call their bank and have the funds wired the next day, if I strike a deal with you.

The problem is that, for minorities, it means going out, raising funds, dealing with bankers you have never dealt with before, and it takes time. If I have a desirable property to sell, I do not want to waste time waiting for a minority to get the money. But if a minority is going to give me a tax certificate, then there is a time value that comes with that tax certificate, and I am willing to wait for him or her to get their money together to make that transaction occur.

So if it is not uniquely geared toward minorities, minorities will not get those transactions. Someone will get a tax capital gains benefit but it will not be the minorities.

Mr. HANCOCK. I appreciate the point that you are making, and there is no question that it works that way. But one of the things that is happening right now in our economy is there are a lot of transactions that are just on the verge of being closed, that are waiting now to see what the U.S. Congress does on capital gains. So the whole thing fits together.

Like I say, I just wanted to make sure that we understand that capital gains, if we get it through up here, benefits everybody, including minorities. That is the only point, and I wanted it in the record.

Thank you very much for your testimony.

I guess this is the final panel for the day. I am assuming most of you have been here since the hearing started this morning and know there has been a lot of testimony. As you have been here, you know we are going to stick fairly close to the 5-minute time limit. Your written statements will become part of the record, and we would appreciate it if you would keep your verbal testimony as concise as possible so we can abide by the 5-minute testimony rule.

We are not going to cut you off. You have taken your time to be here, and we want to make sure that you have the opportunity to make your full statement.

So with that, Mr. Oxendine.

STATEMENT OF JOHN E. OXENDINE, PRESIDENT AND CHIEF EXECUTIVE OFFICER, BROADCAST CAPITAL FUND, INC., AND PRESIDENT AND CHIEF EXECUTIVE OFFICER, BLACKSTAR COMMUNICATIONS, INC.

Mr. OXENDINE. That is correct, thank you. Thank you Congressman Hancock, and I really appreciate the opportunity to be here today. I have my comments for the record and I am just going to make a few points.

Right now I am president of the Broadcast Capital Fund. We have funded, made 50 commitments to minorities over the last 14 years I have been running the company; two-thirds black station owners and one-third Hispanic small deals. We have used tax certificates.

I am also president of a company called Black Star Communications. I own three little television stations. I also spent the last 2 years on the Small Business Advisory Committee at the FCC, working on what we could do for small businesses, women, and rural telephone companies.

I would just like to say for the record that I certainly support the minority tax certificate, even though it has its challenges, for two major reasons.

The first is that it is important for diversity. In the 50-some-odd deals that we have done, we have found that it is important to have ownership. When you look at the 300-plus television markets around the country, if we, as minorities, do not have the No. 1, 2, 3, or 4 stations in terms of ratings and market share, it is important that we be able to find financing so we can own some of the smaller stations in the market. We usually own or can purchase most of the smaller stations in the market.

Most of our deals have been in the small to medium markets and the tax certificates have been very, very important there. Where the owners are there and live in the city of license, we have seen a real change. Because if the ownership is there and there is a diversity of ownership, there is a diversity of message to the community. I have seen that in the 14 years I have been in broadcasting.

Importantly, the tax certificate has facilitated small business development because these are some small radio stations that otherwise would not have been bought.

With regard to the tax certificate, we have seen the tax certificate used primarily to help us (minorities) access capital. It has allowed us to have a "buy-in" to the game. Like Mr. Winston said, in most instances it is the chicken or the egg scenario. If you have a deal, you have to have money. When we go for the deal, if we don't have money, the sellers won't close the deal. So tax certificates have made us attractive.

In the instances where we have used the tax certificate, if a property costs $10 and the majority of the population can pay $10, we come along and offer $7 because there is minimally a 30-percent tax to pay. Usually the seller doesn't give it to us for $7. We get it for $8.5. So the loss, or the deferral of taxes, is really not as much as it could be. It is only $1.50 instead of $3.

In the instances where there are tax deferrals, it is usually in the interest of the seller to reinvest, whether it is the small deals I deal with or the major deal that people are alluding to down the road. If you are an entrepreneur and you have an opportunity to take a tax deferral, if you do not reinvest that money, you are going to have to amend your tax returns for that year and pay interest. Smart entrepreneurs, rather than having their money sitting around idly for 2 years, will invest it in something that will make some money and provide a good return.

So from our experience, the tax certificate has not only been good in generating business in providing access to capital and motivating people to invest in minority-owned companies, but the seller is also motivated to do something entrepreneurial with his tax services. Hopefully, that seller would do so in the community.

Most of our tax certificates have been small. When I came into the business 14 years ago, there were less than 50 minority-owned

broadcast properties, and now there are close to 300-plus. That is still less than 3 percent. Of the 11,000 properties in the United States, anywhere between 500 to 1,000 get bought and sold every year. The couple hundred that represent the tax certificate deals over the past 15 years have not been bad or very costly.

But when you look at radio, TV, cable—radio, financing radio transactions has worked very effectively because when you own radio you have to be part of the community or you will not make it. With television station ownership, you do not have as much control in programming, but if you are the owner, your feelings and concerns are reflected in the community for the things that are important to us (minorities). For cable, it is a little more difficult because it is larger and less local. But our experience overall has been pretty good, and I will defer to my colleagues.

[The prepared statement follows:]

Testimony of

JOHN E. OXENDINE
President and Chief Executive Officer,
Broadcast Capital Fund, Inc.
&
President and Chief Executive Officer,
Blackstar Communications, Inc.

before the

Subcommittee on Oversight
Committee on Ways and Means
House of Representatives
January 27, 1995

Madam Chairman and members of the Subcommittee, thank you for the opportunity to testify today as you begin to examine tax certificates in communications ventures under Section 1071 of the Internal Revenue Code.

As the President of Broadcast Capital Fund, Inc. ("**Broadcap**"), a venture capital company which has financed nearly forty minority broadcasters, and as the President of Blackstar Communications, Inc. ("**Blackstar**"), a minority owned and controlled company which has three television stations, let me express my strong support for the use of tax certificates to increase diversity among the trustees of the public's airwaves.

Let there be no doubt that the FCC's tax certificate policy has directly led to a significant increase in diversity of broadcast ownership in the United States. For more than seventeen years, the Federal Communications Commission has used tax certificates to promote broadcast ownership by new entrants previously precluded from ownership through historical patterns of discrimination. Both the Congress and the Supreme Court have approved this goal of diversity in broadcast ownership. When the FCC began its minority tax certificate policy, minority-owned stations numbered fewer than fifty -- less than one percent of all broadcast stations. We now have over 320 minority-owned commercial broadcast stations. The FCC has issued approximately 280 tax certificates with respect to broadcast stations. While I don't know precisely how many of those acquiring broadcast stations through tax certificates currently own and operate the same broadcast stations today, the FCC's tax certificate policy contributed significantly to a broader, more diverse, and more competitive broadcast marketplace.

Let there also be no doubt that much remains to be done to tear down the barriers to wider participation in broadcast ownership and to foster a level, competitive playing field in which opportunities are available for broad participation in this industry. Tax certificates are vital to this important effort. For example, even with the nearly eight-fold increase in broadcast ownership by African-Americans, Asian-Americans, Hispanic Americans, and Native Americans, these Americans combined own and control less than three percent of the more than eleven thousand commercial broadcast stations in the United States. Yet, since 1978 their representation in our population increased from 20 percent to 23 percent, three percentage points. During the same period, however, their representation in broadcast

ownership only increased about two percentage points, from less than one percent to just under three percent.

Why have we not achieved greater diversity in broadcast ownership? Study after study lays the blame on lack of access to capital. Minority business borrowers have less equity to invest, receive fewer loan dollars per dollar of equity investment, and are less likely to have alternative loan sources. Broadcap came into being as a private initiative formed within the broadcasting industry to help tear down that single greatest barrier to broader and more diverse participation in industry ownership. As the President of Broadcap, I can assure you that the FCC's tax certificate policy has contributed to our successes in fostering diversity in broadcast ownership by funding new entrants. The tax certificate policy does what it is designed to do: it encourages existing owners seeking a buyer to look beyond the usual prospects, and it attracts investors.

What is the tax certificate, and why does it work? Section 1071 of the Code empowers the FCC to certify that a sale or exchange of property is necessary or appropriate to effectuate a change in its broadcast ownership policies. A tax certificate enables the seller of a broadcast station to defer recognizing the gain realized upon a sale, either by: (1) treating the sale as an involuntary conversion with the recognition of gain deferred by the reinvestment of the proceeds in qualified replacement property, or (2) electing to reduce the basis of certain depreciable property, or both. The FCC issues tax certificates to those who sell broadcast stations to minority-controlled buyers. Those providing start-up capital that permits a new minority broadcast venture also can receive tax certificates when they sell their non-controlling interests.

The availability of tax certificates promotes diversity in broadcast ownership in two ways. First, it encourages licensees to consider selling their stations to new entrants. These licensees might otherwise continue to hold their properties or sell to others without considering qualified buyers outside their customary circle of business acquaintances. Second, the availability of the certificate helps these new entrants attract much needed financing so that they can acquire their stations and compete in the marketplace.

Quite simply, no measure that Congress or the FCC has ever taken to foster ownership diversity in the broadcast industry comes anywhere close to the tax certificate program in its effectiveness. Take away the minority-controlled broadcast stations that came into being through the help of tax certificates and you take away a significant portion of the gains that minorities have made in station ownership since 1978. This history of success does not mean that the tax certificate program cannot be improved. I strongly urge, however, that you not allow unsupported allegations of isolated abuse to blind you to the unquestioned good that this program is accomplishing.

The costs of the program are often overstated. A tax certificate does not give the seller a tax credit, but merely permits deferral of the tax on the gain from the sale. If the seller only decided to sell his property because of the availability of a tax certificate, then diversity of ownership has been encouraged without any loss of tax revenue because without the tax certificate, the sale would not have occurred. In any event, the tax certificate holder has a limited period to reinvest in qualified replacement property or to reduce the tax basis in depreciable property already held. The reinvestment itself is often a taxable transaction in which a third party will recognize gain. The cost of the program through postponement of taxation thus may be far less than many have assumed.

Newspapers report only on big tax certificate transactions. The list of the station sales for which the FCC has issued tax certificates, however, includes relatively few major market stations. Most tax certificate transactions have involved medium and small market stations, many licensed to communities not familiar to those outside the state. The huge tax certificate transaction does not typify the usual type of transaction aided by tax certificates. We should not hamstring the entire tax certificate program based upon false assumptions that tax certificates just support megadeals.

I also have heard the concern that the FCC requires only a one-year holding period before a station acquired under the minority tax certificate policy can be sold. In the first place, that concern does not do justice to the FCC. To be sure, the FCC has a one-year bar against the sale of such a station. That rule, however, does not mean that the FCC accepts tax certificate transactions that provide for the controlling parties to withdraw after one year. Rather, the FCC looks for meaningful, long-term gains in diversity of ownership and looks askance at proposals that include mechanisms by which long-established broadcasters can buy out the new enterprise at an early stage.

Some transactions may well have slipped through the FCC's review. The answer to these abuses, however, is not to terminate the program, but to strengthen enforcement and review by the FCC. In December 1994, the FCC began a rulemaking proceeding to consider how to improve the effectiveness of its current programs to promote ownership diversity, including the tax certificate program. In that proceeding, the FCC is well able to consider whether it needs to limit devices that might permit well-established broadcasters to buy out the new entrants fostered by the tax certificate policy, and to obtain the benefits of tax certificates without contributing to the important objective of increasing ownership diversity. If the FCC should find that stations acquired with tax certificates are lapsing back into the control of long-established broadcasters, it could impose a longer required holding period, with appropriate exceptions.

In short, I urge you not to dismiss an entire program because of isolated abuses or perceptions of abuse. Instead, allow the FCC -- the expert agency that Congress established -- to complete the proceeding that it began in December. If the FCC's action does not address this Subcommittee's concerns, it is of course your prerogative to revisit the program. Then, however, you will have the factual record of the FCC's proceeding to guide you in any necessary action to ensure that the merits of the tax certificate program are preserved.

Mr. HANCOCK. Thank you.

STATEMENT OF DOROTHY E. BRUNSON, PRESIDENT, BRUNSON COMMUNICATIONS, INC., PHILADELPHIA, PA., AND PRESIDENT, ASSOCIATION OF BLACK-OWNED TELEVISION STATIONS

Ms. BRUNSON. Mr. Chairman, my name is Dorothy Brunson. I am the president of Brunson Communications, Inc., which owns and operates a station, channel 48, in Philadelphia, Pa. I am also the President of the Association of Black Television Station Owners.

I have worked for 32 years in the communications industry, and during that time I have vigorously worked to bring new business ventures into the marketplace, created new jobs, and promoted economic growth.

To deviate from my remarks one bit, it is very important that we view this tax certificate policy as an economic stimulus and not as a social issue. It is no different from any other policy which stimulates growth, whether it be at the Federal level for various and sundry departments of our government, or whether it be at the State level.

When I started my company, I had to divest everything that I owned and put at risk my entire 20-some-odd years of business. I had a very difficult time borrowing, simply because the complexities of dealing with the broadcast industry by traditional lenders makes the process for minorities, especially those with little experience or who have never owned before, a very difficult one. In spite of that, and the fact that I could not borrow the kinds of funds that were necessary, I succeeded and now employ 20-plus people.

Section 1071 is an important mechanism for helping minorities to gain access to capital. Now, that statement presents a very different kind of view than what you might have heard earlier, but minorities have always been allowed to own properties. Mostly very low grade properties, very unacceptable, and the properties themselves have not really gotten us into mainstream. What it has done is gotten us in trouble and created a mechanism by which we have failed because the properties themselves were inferior.

Section 1071 gives us access to capital, because for once we are able to get quality properties, and those properties can give us the kind of cash-flow and the kind of benefits where we can pay back huge debts. Therefore, lending institutions look at us and look at our deals in a more traditional sense as opposed to looking at it as a broadcast deal where it is one that "I don't understand the complexities of," or one that doesn't make economic sense. It has cash-flow and it has the other components that make a significant difference in terms of access to capital that we would never be able to have without section 1071.

The situation created by selling to a minority is that it allows this minority to provide growth to a division of a company. Historically, when a division is sold off, that smaller division has grown and expanded into a larger division. If you were to allow me to read from my paper, some years ago the FCC required CBS to spin off a small business it operated in the cable television and program syndication field. Those spun-off businesses became the basis of

Viacom. From that modest beginning, Viacom has today grown to a size at least as large as its beginning. Now Viacom has focused its energy on businesses other than cable television. It wants to sell to a minority individual who wants to do and is doing the same kind of thing.

It is my experience, after having worked in this industry for over 32 years and worked in the economic development arena for over 40 years, that any time one uses tax to stimulate small business growth, it is good for America. Further, it provides the kind of economic benefit and the kind of jobs and growth opportunity and tax base for the community it is in by stimulating growth for that community. That is what section 1071 does.

Section 1071 stimulates economic growth in other ways. It allows communications firms to defer recognition of capital gains. It encourages those firms to invest in businesses and facilities that will yield long-term growth, which is one way to stabilize America's tax base. This is much like the capital gains tax and other measures that are being favored by Congress. But under section 1071 the tax will, will eventually be paid. It is not something that is deferred and then goes away forever, as many of the government programs which exist to help other agencies within the government.

This effect is also similar to that of many other provisions in the Tax Code. Those provisions also stimulate investment through targeted treatment of capital gains, and that is what we are talking about, targeted treatment of capital gains.

Unlike section 1071, many of those targeted treatment of capital gains provisions do not require eventually full payment of the capital gains tax. In each case, Congress has determined that in the long term, tax revenues will be increased, not reduced by policies that promote economic growth. Section 1071 accomplished this precisely with the exact same results as any other division.

I appreciate the opportunity to talk with you today and hope these remarks will be considered.

[The prepared statement follows:]

January 27, 1995

TESTIMONY OF DOROTHY E. BRUNSON
President, Brunson Communications Inc.
(WGTW TV, Philadelphia, PA)
President, Association of Black Owned Television Stations

Before: Subcommittee on Oversight
Committee on Ways and Means
United States House of Representatives
Hon. Nancy L. Johnson, Presiding

Good morning Madame Chairperson and members of the committee. I am Dorothy Brunson, President of Brunson Communications Inc., which owns and operates a television station on channel 48 in Philadelphia, Pennsylvania. I am also President of the Association of Black Owned Broadcasters. I have worked for 32 years in the communications industry. In that time, I have worked vigorously to bring new business ventures into the marketplace, creating new jobs and promoting economic growth. But, Madame Chairperson, no one can create new business enterprises without access to capital.

Let me tell you about my recent experience in starting up TV channel 48. Two and one half years ago, I struggled to construct TV 48. Even with a construction permit in the fourth largest market, I could not borrow from any lending institution. Banks and other lenders would not do loans for a specialized business like broadcasting--certainly not for a start-up company like ours. To get on the air, I had to sell everything I owned, including my life insurance policy. We also set up a private placement funding instrument to repay our investors, which netted out to a very high rate of return. All those steps allowed us to put our station on the air. We now employ 20 people.

Even with the great sacrifices I have had to make, I was lucky. TV 48 is a reality today because of my 30 years of experience in the broadcast industry. But the sad fact is that for many minorities, access to capital remains a major hurdle. It is a hurdle that keeps many minority entrepreneurs from ever starting up their enterprises. When those enterprises are not started, everyone is robbed of the jobs and economic growth they would have provided.

Section 1071 is an important mechanism for helping minorities gain access to capital. Large communications firms receive the right to defer recognition of their own capital gains. In exchange, they help minorities acquire smaller parts of their communications businesses. Those minorities, given a

chance to build something of their own, focus all their energy and entrepreneurial spirit on those businesses. They grow the businesses. The prior owners, who have focused their attention elsewhere, would never have expanded these businesses in anything like the same proportions.

Here is a case in point. Some years ago, the FCC required CBS to spin off small businesses it operated in the cable television and program syndication fields. Those spun-off businesses became the basis of Viacom. From that modest beginning, Viacom has today grown to a size at least as large as CBS itself. Now Viacom has focused its energies on businesses other than cable television. It wants to sell that business to a minority individual with a proven record of operating successful cable television systems. If that individual is permitted to acquire Viacom's cable systems, he will, I believe, build upon them in the same way Viacom built upon CBS's spun-off businesses twenty years ago.

The result will be a bigger and better company--providing more jobs--than would otherwise exist. And that will not occur without the tax certificate policy.

Section 1071 stimulates economic growth in another way. By allowing communications firms to defer recognition of capital gains, it encourages those firms to invest in businesses and facilities that will yield long term growth. This effect is very much the same as the effect of reducing the capital gains tax, a measure favored by many in Congress. But under Section 1071 the full tax must eventually be paid.

This effect is also similar to that of many other provisions in the tax code. Those provisions also stimulate investment through targeted treatment of capital gains. Unlike Section 1071, many of those provisions do not require eventual full payment of the capital gains tax. In each case, Congress has determined that in the long term, tax revenues will be increased--not reduced--by policies that promote economic growth. Section 1071 accomplishes precisely the same result.

Madame Chairperson, I appreciate the opportunity to talk to the committee today. I know the committee will deliberate carefully on this important issue, and I hope I have contributed to those deliberations.

Mr. HANCOCK. Thank you, Ms. Brunson.
Mr. Cornwell.

STATEMENT OF W. DON CORNWELL, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, GRANITE BROADCASTING CORP., NEW YORK, N.Y.

Mr. CORNWELL. Thank you, Mr. Chairman, for allowing me to testify today. I am Don Cornwell, chairman of the Board of Directors and chief executive officer of Granite Broadcasting Corp. In addition to my duties at Granite, I am also active in the broadcasting industry as a member of the television board of the National Association of Broadcasters, and I appreciate the opportunity to appear today before you in support of section 1071 of the Tax Code.

The development and growth of Granite into the largest African-American controlled company in the television station ownership business in this country is a testament to the success of the tax certificate and section 1071. To date we own and operate six network affiliated television stations across the country, in California, Illinois, Minnesota, Wisconsin, Indiana, and New York. We are closing on a seventh station in Texas next week and expect to complete the acquisition of a station in Michigan in June.

Let me explain how we got started. In 1988, Granite bought its first and smallest stations in Duluth, Minn., and Peoria, Ill. We started small because my own equity capital combined with that of family, friends, and former employers was used to purchase these stations. My investment, which represented then and today virtually all of my family's net worth, bought the majority of the voting stock in Granite. No one has the right to buy my equity position or to exercise any of my rights as the controlling shareholder.

Over time, our reputation has grown, and, as a result, we have been able to attract the large amounts of capital necessary to acquire larger stations. I want to emphasize to the subcommittee that our objective since 1988 has been to build a strong company, a company which can compete in the 21st century. Thus, we continue to own each station we have acquired to date, despite receiving many attractive offers to sell.

My own experience tells me that the minority tax certificate program accomplishes the FCC and Congress' goal of encouraging program diversity. There is no doubt in my mind that editorial policy does follow ownership. While I am careful, I might add, not to inject myself into station manager's programming decisions, since we really do believe in localism, in several instances there is no question but that our ownership has resulted in programming that was more diverse than that provided by previous owners.

Now, I might add, we give some examples that will be in the written comments submitted into the record.

The tax certificate program has been extremely important in the development and growth of our enterprise. While valuation and certainty of financing ultimately, frankly, determines the willingness of a seller to choose our proposal, clearly the tax certificate has been very helpful in persuading owners to pay close attention to a proposal from us.

For example, we were able to persuade companies such as Pulitzer, Landmark Communications, and Meredith to sell us tele-

vision stations which they, frankly, had not intended to sell. I might just add as an aside that I disagree with the gentleman on the previous panel, because we have gotten benefits in the pricing. Some would say I am a pretty tough negotiator despite the smile on my face.

The certificate's value depends solely on the seller. At the outset of our negotiations we cannot be sure that a seller will find our proposal the most attractive. The seller must consider whether they expect to realize any taxable gain and whether they intend to reinvest the proceeds of a sale in acceptable like-kind property. The certificate's actual value can be uncertain, and sometimes not large in dollar terms. However, I must assure you that in each of our six acquisitions to date, and the two currently under discussion or under way, there would be no deal without the certificate.

We share the concerns of the Congress and the FCC about potential abuses of this program, and we welcome an opportunity to work with you to develop ways to ensure that the spirit of this program is satisfied. We believe that satisfaction of that spirit requires at least three standards:

First, a significant at-risk investment by minority investors at the inception of the enterprise. Second, executive management control. Third, the absence of any mandatory rights by nonminority investors to buy out the controlling minority investor.

Further, we believe that the Congress, the FCC, and the IRS should require a written representation and warranty from the recipient of the tax certificate, i.e. the seller, that these or other appropriate standards have been met to the best of their knowledge.

Granite has set an additional standard for itself for participation in this program. Our standard is inappropriate as an act of legislation, but we would like to go on record as to what our practice has been.

We believe that our company has realized and our shareholders have realized benefits from the program and, therefore, one should expect more from us than one might expect from an average company in our industry. Thus, we have gone out of our way, despite the fact that we are not a rich company, to stretch to create paid station employee opportunities as a means of providing young people, mostly minorities, I might add, an opportunity to gain entry level employment in our company and this industry.

In addition, we have contributed significantly to industry-supported foundations which are designed to encourage minority students to enter the broadcasting field.

We also have made available our station and management to assist in training minorities who participate in a Commerce Department program for prospective owners. It is a training program.

This concludes my remarks. Thank you for allowing me an opportunity to testify.

[The prepared statement follows:]

STATEMENT OF

W. DON CORNWELL

CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER
GRANITE BROADCASTING CORPORATION

Chairwoman Johnson, Congressman Matsui, and Members of the Subcommittee on Oversight, my name is Don Cornwell. I am Chairman of the Board of Directors and Chief Executive Officer of Granite Broadcasting Corporation ("Granite"). In addition to my duties at Granite, I am also active in the broadcasting industry as a member of the television board of the National Association of Broadcasters. My company is also a member of the National Association of Black Owned Broadcasters. I appreciate the opportunity to submit testimony on section 1071 of the tax code, which the Federal Communications Commission ("FCC") has used to issue tax certificates which encourage greater ownership by minorities of radio, television and other properties.

Background on Granite's Operations

The background information on our operations highlights the benefits of the FCC tax certificate program. Granite owns and operates six network affiliated television stations across the country, all of which were acquired under this program. We have stations in California, Illinois, Minnesota, Wisconsin, Indiana and New York. We are also in the process of acquiring stations in Texas and Michigan.

We bought our first and smallest stations in 1988. These stations, which are located in Duluth, Minnesota and Peoria, Illinois, are necessarily small because my own equity capital, combined with that of family, friends and a former employer, was used to purchase them. Over time, Granite was able to develop a strong reputation enabling it to attract the amounts of capital required to acquire larger stations.

Over the next four years, we acquired four additional network affiliated television stations and a large interest in a fifth station. In 1989, we acquired stations in Fort Wayne, Indiana and San Jose, California. In 1993, we acquired stations serving Fresno, California and Syracuse, New York, and the largest equity stake in the leading television station serving Buffalo, New York.

By the end of 1995, Granite will consist of eight stations (plus our equity interest in the Buffalo station) competing in television markets ranging in size from Grand Rapids-Kalamazoo-Battle Creek, Michigan to Duluth, Minnesota-Superior, Wisconsin. These markets range in size from the 36th to the 128th market. We will employ approximately 750 individuals; and, after six years, we will have become the largest African-American controlled company in the television station ownership business.

Our objective is to ensure that Granite is strong enough to compete in the electronic media market in the 21st century. We will remain builders; and, thus, we have not and will not engage in the trading of stations. We continue to own each station we have acquired to date. We have done this despite receiving attractive offers to sell.

We believe that our ownership of each of these stations has made a difference. Each station, while affiliated with one of the three traditional networks, is directed to become the leading provider of local news, weather, and sports information in our communities of service. In addition, we pride ourselves on the strength of our involvement in our local communities.

Development of Section 1071

In the press release announcing this hearing, you indicated that the Subcommittee will examine the FCC's 1978 policy and the implementation of section 1071. Following is a brief background description of the history behind enactment of Code section 1071 and the current tax certificate program. We believe that the history shows that the minority tax certificate program does fit within and further the original goals of section 1071.

The predecessor to section 1071 was enacted in 1943.1/ This provision emanated from the adoption of FCC ownership regulations prohibiting common control of certain directly competing radio stations.2/ These ownership rules were directed toward ensuring diversity in the content of broadcasts.3/ As a result of the new policy prohibition, a number of licensees that held interests in two stations were required to dispose of one of these interests.4/ Lawmakers enacted the predecessor to section 1071 (old section 112(m)) to afford relief, through issuance of tax certificates, to taxpayers who were required to dispose of certain broadcast holdings. Since 1943, the FCC has expanded its multiple ownership rules to prohibit a number of cross-ownerships.5/ Ironically, in more recent years, the FCC has again reversed itself and liberalized the multiple ownership and cross-ownership rules in markets where sufficient diversity of viewpoints is available.

In 1978, the FCC expanded its program to promote diversity of viewpoints. Under this new program, the FCC announced it would issue tax certificates for sales of broadcast facilities to "parties with a significant minority interest" in cases where "there is a substantial likelihood that diversity of programming will be increased."6/ Congress did not change the language in section 1071 when the FCC's new policy was put into effect. Much like its 1943 action in breaking up cross-ownership arrangements because they limited diversity of viewpoints in the marketplace, extending the tax certificate program to minorities was an acknowledgement that its prior actions in granting licenses had failed to take into account the importance of minority ownership and control of licensees in achieving the desired diversity of viewpoints in the marketplace.

1/ Former section 112(m) was enacted as part of the Revenue Act of 1943, Pub. L. No. 78-235, § 123, 58 Stat. 21 (1944).

2/ See S. Rep. No. 627, 78th Cong., 1st Sess. 53-54 (1943), reprinted in J. Seidman, Legislative History of Federal Income and Excess Profits Tax Laws, 1953-1939, at 1602-03 (1954); Statement of Policy on Minority Ownership of Broadcasting Facilities, 68 FCC2d 979, 983 n. 19 (1978) ["1978 Policy Statement"] (tax certificates originally used to remove hardship of involuntary transfer resulting from divestiture imposed by FCC's multiple ownership rules); 47 C.F.R. § 3.35, 8 F.R. 16065 (1943). Before that time, some radio station licensees owned more than one station in the same city. See G.C.M. 37430 (1978).

3/ See, e.g., In re Radio Corp of America, 10 F.C.C. Reports 212, 213 (1943).

4/ See F.C.C. 56-919, 21 Fed. Reg. 7831 (1956).

5/ See Blake & McKenna, Section 1071: Deferral of Tax on FCC Sanctioned Dispositions of Communications Properties, 36 Tax Law Review 101, 104-06 (1980) (citing examples such as elimination of cross-ownership of AM radio stations, FM radio stations, and television stations in same market).

6/ See 1978 Policy Statement, 68 FCC2d 979, 982-93.

Description of Current Minority Tax Certificate Program

Current section 1071 is restrictive and is helpful only in those cases where the seller is in a tax position to use the certificates. If qualified, the tax certificate program can provide effective incentives for a station owner to sell to a minority or for an investor to provide financing for the minority owner.

As currently drafted and implemented, the FCC is allowed to issue a tax certificate only to two classes of taxpayers: (1) a seller of a broadcast station upon the sale or exchange of the broadcast property to a minority-controlled company, or (2) an initial investor who provides the necessary "start-up" financing to a minority-controlled purchaser of a broadcast station.7/ The tax certificate enables the qualified taxpayer (i) to defer payment of capital gains tax on the sale of the broadcast property or interest, provided that the taxpayer reinvests the proceeds in qualified replacement property,8/ or (ii) to reduce the basis of certain depreciable property remaining in the taxpayer's hands immediately after the sale of broadcast property or interest, or acquired in the same taxable year.9/

To qualify under the FCC's minority tax certificate policy, the minority company must demonstrate that it is minority controlled. Traditionally, the test with respect to corporate applicants has been whether minorities10/ own more than 50% of the voting stock.11/ More recently, the FCC has expanded the eligibility requirements to permit limited partnerships with minority general partners to qualify, provided that the minority partner owns at least 20% of the partnership's total equity.12/

Additionally, the issuance of a tax certificate is dependent upon the timing of certain events. A seller of a broadcast property can be issued a tax certificate only after the sale or exchange has actually occurred. Initial investors in a minority-

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7/ For an initial investor to qualify for a tax certificate, the investment must meet the following criteria: (1) the investor must have provided "start-up capital" to the minority enterprise, defined as funds provided within one year of the company's acquisition of a broadcast property; (2) the investor must have sold its interest in the company; and (3) the company must qualify as a minority-controlled company both before the investor purchases the interest and after the investor sells the interest in the company.

8/ Qualified replacement property must be "similar or related in service or use" to the converted property. Thus, such property may consist of hard assets (e.g., broadcast or cable assets) or stock in a corporation whose income is primarily derived from broadcasting or cable operations.

9/ Gain may still be recognized under other Code sections (e.g., depreciation recapture under sections 1045 or 1050. See Glazer & Fisher, Section 1071: FCC-Certified Transactions Involving Minority-Controlled Entities, 47 Tax Lawyer 91, 110-11 (1994).

10/ For the purpose of the FCC's tax certificate policy, the term "minority" includes Blacks, Hispanics, American Indians, Alaskan Natives, Asians, and Pacific Islanders. Minority Ownership in Broadcasting, 92 FCC2d 849, 849 n. 1 (1982) ["1982 Policy Statement"].

11/ 1978 Policy Statement, 68 FCC2d at 983 n.20.

12/ 1982 Policy Statement, 92 FCC2d at 853-55.

controlled purchaser of a broadcast station can be issued a tax certificate only after the sale of their interests in the minority-controlled buyer.13/ A minority company that obtains a broadcast station involving a tax certificate must retain the station for at least one year. This restriction does not apply if a minority company proposes to sell the station to another minority company within the one-year period.

Tax Certificate Program's Significant Impact on Development and Growth of Company

Although we recognize that a number of factors have helped our business succeed, the minority tax certificate program has been extremely important in the development and growth of our enterprise. The program has allowed Granite to acquire each of its existing stations, so that now we are large enough to offer minorities real employment and business opportunities.

Valuation and certainty of financing ultimately determine the willingness of a seller to accept any of our acquisition proposals; however, Granite's experiences indicate that the tax certificate program clearly has been helpful in persuading owners to consider and accept our proposals. For example, we were able to persuade companies such as Pulitzer, Landmark Communications, and Meredith to sell us television stations which they originally had not intended to sell at all.

However, there is no guarantee that the tax certificate will make our proposal the most attractive to a particular seller. In some cases, the seller does not expect to realize any significant taxable gain. In other cases, the seller is going out of business and has no interest in reinvesting the proceeds of the sale in "like kind" property acceptable to the IRS in order to realize the tax certificate's benefits.

Potential Abuses of Program Raises Concern

Granite shares the concerns of the Congress and the FCC about potential abuses of the minority tax certificate program. In that regard, we were extremely careful in the creation of Granite to satisfy what we perceived as not only the letter, but also the spirit, of the FCC's policy.

When I founded Granite in 1988 with a partner, the investment I made represented then and today virtually all of my family's net worth. My investment bought the majority of the voting stock in Granite, and no one has the right to purchase my equity position or exercise any of my rights as the control shareholder. Further, not only do I operate as the Chairman and CEO of the Company, we also have significant minority representation on our Board of Directors.

When we have acquired stations, in many instances the seller has spent a considerable amount of time conducting their own due diligence regarding the structure of Granite. I specifically recall the transaction where Granite acquired our Fort Wayne, Indiana station, WPTA-TV, where the seller's counsel insisted that Granite prove its strict compliance with the law. Such due diligence should be a requirement in every transaction.

My own experience tells me that the minority tax certificate program accomplishes the FCC's goal of encouraging program diversity. While I am careful not to inject myself into my station managers' programming decisions, since we believe in localism, I know of cases where my ownership has resulted in programming that was more diverse than that provided by previous non-minority

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13/ 1982 Policy Statement, 92 FCC2d at 858.

owners. For example, one of our stations, which had never commemorated Black History Month, produced and aired profiles of prominent, local African-Americans during Black History Month, featuring unsung heroes in the community, after the station had been purchased by Granite Broadcasting. Although there is no overt link in this case, I believe that a station's editorial policies in general reflect its ownership's views. The Supreme Court believes so as well.14/

Granite has set an additional standard for itself when it participates in this program. While this standard would be inappropriate as an act of legislation, we would like to go on record as to our practice. We believe that the benefits realized by our Company from the tax certificate policy require us to exceed expectations, that otherwise might exist from the average company in our industry, with regard to helping increase minority representation and thus promoting diversity of viewpoints in the broadcast medium. We are not a rich company, despite our rapid growth. However, we have stretched financially to create paid station employee opportunities as a means of providing young people -- mostly minorities -- an opportunity to gain entry level employment. In addition, we have contributed significantly to industry-supported foundations which are designed to encourage minority students to enter the broadcasting field. We also make available our stations and management to assist in training minorities who participate in a Commerce Department program for prospective owners of new stations.

We welcome an opportunity to work with the Subcommittee and the Administration to develop ways to ensure that the spirit of this program is satisfied. We believe that satisfaction of that spirit requires a significant at-risk investment by minority investors at the inception of the enterprise, executive management control, and the absence of mandatory rights by non-minority investors to buy out the controlling minority investor. Further, we believe that the Congress and the FCC should require a written representation and warranty from the recipient of the tax certificate that these or other appropriate standards have been met to the best of their knowledge.

Another Suggestion to Improve Section 1071

As long as you are examining section 1071, we would like to offer a suggestion to improve the tax administration of this provision. An important requirement of the provision is that the holder of a certificate must reinvest the proceeds in "property similar or related in service or use to the property converted." For this purpose, "stock of a corporation operating a ... broadcast station, whether or not representing control of such corporation," is considered property eligible for reinvestment and tax deferral. In Rev. Rul. 66-33, 1966-1 C.B. 183, the Internal Revenue Service interpreted section 1071 to require that stock in a corporation which holds its licenses and conducts operations through wholly-owned subsidiaries rather than directly, is not "property similar or related in service or use", even when the sole assets of the parent are stock in subsidiaries which hold licenses and operate broadcast stations.

This interpretation is too restrictive. At present, Granite holds one of its licenses directly; the others are owned in subsidiaries. Our lenders are constantly demanding that we hold all of our licenses in separate subsidiaries in order to protect their interests as creditor. Since the Supreme Court has held that

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14/ See, e.g., Metro Broadcasting, Inc. v. F.C.C., 497 U.S. 547, 570-71 (1990) (citing TV 9, Inc. v FCC, 495 F2d 929, 938 (D.C. Cir. 1973), cert. denied, 419 U.S. 986 (1974)).

they cannot acquire a security interest in the licenses itself, they can best protect their interests if they have a pledge of the stock of the subsidiary holding the license, along with negative pledges. It is important that a company like Granite be considered property similar or related in service or use in order to attract additional capital from sellers seeking to reinvest. Yet, lending restrictions make that difficult to maintain and, in many cases, impossible.

No harm would be done to the intent of section 1071 if Rev. Rul. 66-33 were overruled by amending the statute explicitly to permit stock in a corporation primarily engaged in operating radio broadcast stations, directly or through subsidiaries, to be investments eligible for deferral of gain. We would welcome discussions with you or your staff to determine if a resolution of this problem is possible.

Conclusion

Granite's experience with the minority tax certificate program shows that the program serves the intended goals of encouraging minority ownership in the broadcast industry and thus promoting diversity of content in broadcasts. The program has been very important to the growth and development of our Company, and has also encouraged the re-circulation of capital in our economy.

Granite shares Congress' and the Administration's concerns about potential program abuses. The Company has taken great pains to comply with both the letter and spirit of the program. We welcome this opportunity to work with the Congress and the Administration to develop ways to ensure that the program continues to serve its intended purposes, both from a communications policy and tax policy perspective.

Thank you for allowing me an opportunity to testify. I would be pleased to answer any questions.

Mr. HANCOCK. Thank you, Mr. Cornwell.
Mr. Bustos.

STATEMENT OF AMADOR S. BUSTOS, PRESIDENT AND CHIEF EXECUTIVE OFFICER, Z-SPANISH RADIO NETWORK, INC., CAMERON PARK, CALIF.

Mr. BUSTOS. Yes, that is correct.

Mr. Chairman, Mr. Hancock, the tax certificate was intended for people, entrepreneurs, like us. In your rush or eagerness to not reward Viacom with a lot of money, please do not sacrifice us. I can see your concern and the subcommittee's concern, but do not sacrifice the people that otherwise would be benefiting from this kind of program.

My name is Amador Bustos, as you mentioned, and I am the president and chief executive officer of Z-Spanish Radio Network. Z-Spanish was formed only 2 years ago, 2 years and a couple of months. So even though some of the companies here have a lot longer trajectory, we are a smaller company and a newer company, which is part of the reason why the tax certificate was so important and crucial to us.

Currently, we operate and own a radio network of eight stations in the western United States. They are all Spanish and we produce a network that is delivered via satellite to all of our stations. Now we currently employ approximately 80 people and 90 percent of those employees are Hispanic.

On behalf of Z-Spanish and all other minority broadcasters in the United States, I urge the Congress to allow the survival of the tax certificate even if they may be modified to be improved, because it has the most effective role in prying open the door for access to ownership to broadcasting radio licenses to bona fide minority entrepreneurs. The prying, the opening of the door, is really the issue of access, because if you do not have at least that window of opportunity, then you do not have access.

For 20 years I have worked to become an owner of radio broadcast properties. As is evidenced by the attachment in my statement, you have a plan for the development and acquisition of broadcast stations for the Latino community, which Mr. Joseph Aguayo and myself presented to the FCC when they had their conference on minority ownership on April 26, 1977, that is 1 full year before the minority tax certificate was implemented, while I was already before the FCC as a graduate student trying to get the minority access to the broadcast industry.

A lot of that came also from reading and being a student during the days of the Civil Rights Commission and reading the documents on window dressing on the set, and all of the other things that went along with the Commission reports. So 20 years later, here I am again.

Our statements in 1977 urged the Small Business Administration to repeal its Opinion Molder Rule which effectively banned the SBA participation in loans in the broadcast industry. Our advice was not heeded then. It took almost 18 years, until last year, when they finally repealed that rule.

Our 1977 statement also urged the FCC to take steps to provide minority businessmen and women access to the growing television

and cable industry. Our advice was not heeded very well either, because the minority representation in that industry is very small.

For us, the issue in 1977 was access and opportunity, fairness and justice. In 1995, the issue remains exactly the same, Mr. Hancock. In 1977, minorities owned approximately, as you heard, 1 percent. Now it is about 3 percent.

There has been some minor improvement, and that improvement, I think, has to do mainly with the effectiveness of the tax certificate. The effectiveness of the tax certificate resides in the fact that it stimulates the existing owners of broadcast and cable properties to actually talk to us, to seek minorities, to assist us in qualifying to actually purchase their properties.

This policy is truly driven by the market economy and the private negotiations of a buyer and seller. It is also one of the policies that, from a regulatory standpoint, the FCC can afford to offer to minorities—a very short turnaround period from where they can become nonowners to owners. People have talked ability, some of the other benefits or other preferences that the FCC has. Those are not as effective.

The broadcast properties are extremely limited commodities. Even if I had the money, I could not simply start my radio station in a community of my choice. The top 100 markets are virtually all taken. A minority entrepreneur has now only two choices: he can either seek a license from the FCC or buy an existing one. The seeking of the license is a very long process and it is also very costly. Litigation is very expensive and time consuming.

I have, for 10 years, applied for construction permits through the FCC and I have not gotten a single one. The fact is that people always litigate you to death and for one reason or another.

On the other hand, the view of a tax certificate policy, the seller will provide in the owner—or the potential brokers will call you from all parts of the country to try to offer you properties because they know they have that tax certificate.

So the basic principle; do not sacrifice the many, many entrepreneurs that are new to the industry, that are coming in, because there is one big mega deal. There may be something you can do about the mega deals, but the greatest majority of people that are benefiting from the certificate is ourselves. I have a track record of 20 years of trying to get properties and not being able to succeed until 2 years ago and that is because of the access of capital.

Typically, in those circumstances back before the tax certificate, white men sought to sell their properties to other white businessmen. They did not even offer the properties to us, and it was only the tax certificate that made the difference in terms of being able to bring those to the table.

To conclude, I know the battle of the minority issues of the sixties and seventies are out of fashion with many policymakers today. However, when we juxtapose the study I presented to the FCC two decades ago with the situation today, it can be seen that only very little has changed, and that minorities control very few stations. However, if you want to modify the certificate, do not repeal it and only improve it.

Because if you repeal it, Congress would be tantamount to saying that minorities have now gained equal status, have equal oppor-

tunity, have equal access, and that racism has been eradicated from the United States, which is clearly not the case.

My appeal to this subcommittee, and I am going to conclude, and this Congress, as it attempts to reshape this country with its Contract With America, that it be sure it includes all Americans: Black Americans, Hispanic Americans, Asian Americans, and Native Americans. The Speaker, I heard him last night at the dinner on television, he spoke to that effect; that the Contract With America was going to include all Americans. Because if it does not, it will become a contract on America, and a death warrant to the ideals of equality and justice that this country was built on.

Thank you, sir.

[The prepared statement and attachments follow:]

TESTIMONY OF AMADOR S. BUSTOS
TO THE WAYS AND MEANS COMMITTEE,
UNITED STATES HOUSE OF REPRESENTATIVES
CONCERNING THE FCC'S MINORITY TAX CERTIFICATE PROGRAM

My name is Amador S. Bustos. I am President and Chief Executive Officer of Z-Spanish Radio Network, Inc. (Z-Spanish). Z-Spanish was formed just over two years ago. It is headquartered in the Sacramento, California metropolitan area. Z-Spanish currently owns and operates eight radio stations in the western United States. Z-Spanish established and operates "La Zeta", the first United States-based Hispanic-owned radio network, offering Spanish-language music and entertainment nationwide via satellite. Z-Spanish currently employs approximately 80 people, of whom 90 percent are of Hispanic origin (See Exhibit A).

On behalf of Z-Spanish and all other minority broadcasters in the United States, I urge Congress to permit the survival of the Minority Tax Certificate Program[1] because it has been one of the most effective tools to "pry" open the door for access to ownership of broadcast radio licenses by *bona fide* minority entrepreneurs.

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[1]See 26 U.S.C. §1071; ***Statement of Policy on Minority Ownership of Broadcast Facilities,*** 68 FCC 2d 979 (May 25, 1978).

For twenty years I have worked to become an owner of radio broadcast properties. As evidence of this please see Exhibit B, "A Plan for the Development and Acquisition of Broadcast Stations for the Latino Community", which Mr. Joseph Aguayo and I presented on behalf of National Latino Media Coalition to the FCC Conference on Minority Broadcast Ownership on April 26, 1977, one full year before the Minority Tax Certificate Program was adopted.

Our 1977 statement urged the Small Business Administration to repeal its "Opinion Molder Rule", which effectively banned SBA participation in loans for the acquisition and operation of broadcast station. Our advice was not heeded until last year when the SBA finally repealed the rule. Our 1977 statement also urged FCC to take steps to provide minority businessmen access to the then-growing cable television industry.

For us, the issues in 1977 were access and opportunity, fairness and justice; in 1995, the issues remain the same[2].

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[2]The Supreme Court of the United States in ***Metro Broadcasting, Inc. v. FCC***, 497 U.S. 547, 610-11, wrote: "Our history reveals that the most blatant forms of discrimination have been visited upon some members of the racial and ethnic groups identified in [FCC minority preference] programs. Many have lacked the opportunity to share in the Nation's wealth and to participate in its commercial enterprises. It is undisputed that minority participation in the broadcasting industry falls markedly below the demographic representation of those groups . .

In 1977, minorities owned approximately 1 percent of the then-existing broadcast stations. Eighteen years later, minority individuals and/or companies today own less than 3 percent of the commercial radio and television stations in America.[3]

In my view, the single most effective instrument in achieving the modest gains which have occurred over the past two decades, of all the minority incentives given by the FCC, has been the tax certificate.

Its effectiveness resides in the fact that it stimulates existing owners of broadcast and cable properties who desire to sell their stations or systems to actively and aggressively seek out and assist qualified minority entrepreneurs. This is a policy that is truly driven by a free market economy and the private negotiations between

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. . . and this shortfall may be traced in part to the discrimination and the patterns of exclusion that have widely affected our society. As a Nation we aspire to create a society untouched by that history of exclusion and to ensure that equality defines all citizens' daily experience and opportunities as well as the protection afforded to them under law."

[3]In its January 12, 1995 "Notice of Proposed Rulemaking" in MM Docket Nos. 94-149 and 91-140, ***Policies and Rules Regarding Minority and Female Ownership of Mass Media Facilities***, FCC 94-323, 10 FCC Rcd --, at paragraph 5, the FCC reports that, as of June 30, 1994, "minorities represented almost 23 percent of the national workforce but control only 2.9 percent (323) of the 11,128 commercial radio and television stations on the air. Similarly, of the approximately 7,500 cable operators, 0.2 percent (15) are minority-controlled." [footnotes omitted].

seller and buyer. It is also one of the only policies that, from a regulatory standpoint, the FCC can offer which are truly effective and help to place minority entrepreneurs into broadcast ownership in relatively small period of time.

As you know broadcast licenses are an extremely limited commodity. Even if I have the money, I cannot simply start my own radio station in a community of my choice. In virtually all of the "top 100" media markets, all existing and available space in the broadcast spectrum is occupied by operating stations. A minority entrepreneur such as myself has only two options: (1)to seek a license from the FCC[4]; (2) or to buy an existing one. Despite all the minority preferences provided by the FCC in the comparative hearing it is extremely difficult to get a license through this method. In my case I have filed numerous applications for construction permits for new FM stations for almost 10 years and have not gotten a single one through a decision of the

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[4]The only way this can be done in most markets is to file an application in competition with the renewal of license application of an existing station (radio licenses are renewed every seven years; television licenses are renewed every five years); in most cases, unless the existing licensee has a demonstrated record of violations of the Commission's Rules or has been convicted under narcotics trafficking statutes, such a challenge generally is futile, as the FCC has a "renewal expectancy" policy which generally favors the granting of the renewal application and the denial of the challenger's application.

FCC. Rather, because of the length of time the process takes and its high expenses, I have been "beaten by money". In other words, in most cases I have been forced to settle because our competitors have had more money and resources.[5]

On the other hand, in view of the tax certificate policy, sellers of broadcast and cable properties are incentivized to make their properties available to minority entrepreneurs. In my own experience, I receive calls from both owners of stations and business chance brokers specializing in the mass media industry at least once a week, informing me of properties for sale throughout the country and soliciting me to purchase them. These calls do not just come from the state of California, but from brokers all over the nation. For example, we recently purchased an AM/FM combination in the Fresno, California market after being solicited by a broker from Tampa, Florida. Twenty years ago, this type of business climate did not exist in

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[5]I am a non-voting stockholder in an application for a new station which has been pending at the FCC since 1987 and has still not been resolved; I am also an individual applicant in a challenge against an existing station's renewal application which has been pending since February, 1990. Despite the FCC's rhetoric in which it publicly claims to be interested in helping minorities, its staff's performance in the processing of hearing cases would not lead one to believe that the FCC is truly interested in increasing minority ownership.

our country. Typically, white businessmen sought out and sold their properties to other white businessmen. They did not even think to offer their properties for sale to members of the minority communities in this country. The tax certificate policy ensures, for economic reasons, that a competent businessman will always give a fair shake to a minority businessman to purchase his property.[6] The FCC then processes applications for its consent to the assignment of licenses of radio and television station typically in a 60-90 day period.

The issue of the Minority Tax Certificate is not an economic issue of quantifying how much the treasury is losing because the issuance of a certificate does not provide a tax credit. The issuance of a tax certificate only involves a tax deferral, generally for no more than 3 years, and only if the gain from the sale of the broadcast station to a minority-controlled company is reinvested in the communications industry. This program does not deprive the federal Treasury of revenues by forgiving a tax that might otherwise be due on the gain after a sale of a

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[6]Unlike renewal applications, applications for the sale of broadcast properties cannot be challenged by competing applications (although they are subject to petitions). *See* 47 U.S.C. §310(d).

broadcast property. Rather, taxes are deferred. The minority tax certificate program is both good public policy and good tax policy, because (1) it brings qualified minorities into the broadcasting industry, thereby diversifying control of the mass media and continuing to keep the door open for minorities to have a voice and access to the vital means of communication, and (2) it keeps money flowing through the mass media industry and sustains it as a dynamic and growing industry which is the best of its kind in the world and provides great service to the public. The same theoretical argument that is use to justify the reduction in the capital gains tax applies to the protection of the tax deferral given by the Tax Certificate; provides capital for expansion, employment, productivity, consumption and eventual revenues for the treasury through sales and income taxes.

To conclude, I know that a lot of the minority issues of the 1960s and 1970s are "out of fashion" with many policy makers today. However, when one juxtaposes the study that I presented to the FCC some two decades ago with the situation today, it can be seen that only very little progress has been made. Minorities own a controlling interest in just 323 of the 11,128 commercial broadcasting

stations and just 15 of the 7,500 cable television systems in the nation. This extremely low percentage fails to come close to the 23 percent of the workforce which minority individuals comprise. The tax certificate policy has been a singularly successful means of bringing new minority entrepreneurs into the mass media industry. It has been said that non-minority investors have been abusing the system by using "minority" front persons. The Commission has means available to detect "shams" and to prevent abuses; for example, it could designate tax certificate applications for hearings before administrative law judges to determine whether the minority in question is *bona fide*.[7] Clearly, it is in the public interest for Congress and the FCC to develop means to curb abuses of otherwise beneficial programs.

However, a repeal of the tax certificate would be tantamount to Congress saying that minorities have now

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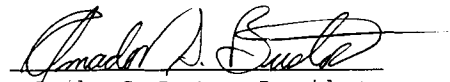
[7]The Supreme Court of the United States noted in ***Metro Broadcasting, Inc. v. FCC***, 497 U.S. 547, 595, n. 48, that FCC minority preferences are subject to administrative scrutiny to identify and eliminate from participation those applicants who are not bona fide. The FCC's adjudicatory staff has well over 10 years experience in ferreting out those applicants who seek minority preferences by "sham" ownership devices but who are in fact undeserving of those preferences. See e.g. ***KIST Corp.***, 99 FCC 2d 173, 186-90 (FCC Rev. Bd. 1984), *affirmed as modified* 102 FCC 2d 288, 292-93 and n. 11 (1985).

gained equal status, have equal opportunity, and equal access, and that racism has been eradicated from the United States, which is clearly not the case at this time. The tax certificate policy works, enhances minority ownership of and participation in the mass media, and in the long run does not result in a government forgiveness of tax liabilities. It is good tax policy and good social policy, and Congress ought to let it stand.

My appeal to this committee and the Congress as it attempts to reshape this country with its "Contract with America" that it be sure to include all Americans, Black Americans, Hispanic Americans, Asian Americans and Native Americans. Without fair access for all citizens will become a "contract on America;" a death warrant on the ideals of equality and justice that this country was built upon. Those are the precious principles that the founding fathers embodied in the Constitution that you have sworn to uphold. So, when you deliberate the fate of the tax certificate policy, be sure that tomorrow's America continues to be the land of opportunity for all, not just for the rich and famous; that America continues to be the land that rewards the entrepreneurial spirit, not only the concentration of capital into "mega"-companies; and that tomorrow's America

continues to be the land of equality and justice, not tyranny and discrimination.

Respectfully submitted,



Amador S. Bustos, President
Z-Spanish Radio Network,
Inc.

DATED: January 27, 1995

Z-Spanish Radio Network!

What's Driving Hispanic Market Growth?

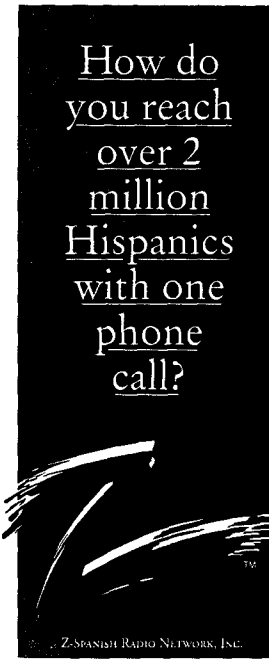
- More Hispanics were added to the population during the 1980s than all other minorities combined.
- Hispanics increased *seven times faster* than the rest of the population during the past decade.
- In two decades Hispanics will outnumber African Americans and become the nations largest minority group.
- Hispanic purchasing power swells to over $200 Billion.

Why Spanish Language Media?

- Hispanics make up one-quarter of the California population and represent 46% of the population growth in California.
- Over 75% prefer to speak Spanish.
- Strong desires to maintain cultural roots.

Contact your Z-Spanish Radio Representative.

Z-Spanish Radio Network, Inc.
340 Brannan Street, Suite 101
San Francisco, CA 94107
Tel: (415) 284-9200
Fax: (415) 284-9205



"La Z's" Program Director hand picked his "Dream Team." The combination of a distinctive format and nationally renowned talent, coupled with state-of-the-art technology to deliver a flawless, CD quality sound, give "La Z" a sophisticated, modern sound.

Raul Brindis
6am - 12pm
Raul has a team of supporting characters that make the morning at La Z "wackier" than any "morning zoo." Their high energy, jokes, character impressions, gossip on entertainers, and laughter wake up the audience and gets them in a good mood for the day ahead.

Salvador Homero Campos
3pm - 7pm
Sal's powerful air presence and magic touch for mixing music has commuters dancing in their seats during the drive home. He has three distinctive programs: "La Hora del Trabajador" (Workers Hour), "Los Grandes Anos del Rock" (Spanish Rock greatest hits), and "La Hora de Los Novios" (Love Lines).

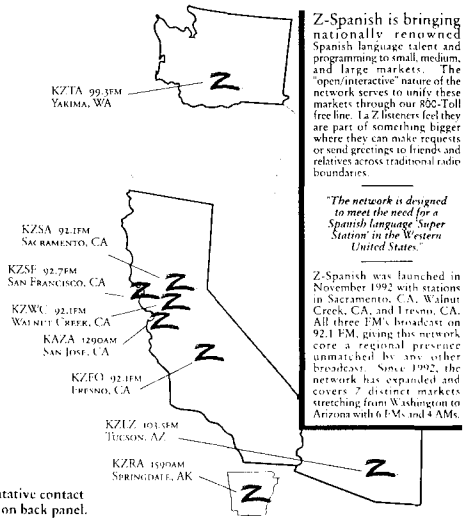
Gonzalo Siles
7pm - 12midnight
Gonzalo is the creator of "La Hora Romantica" (Romantic Hours) where listeners read original poems during an hour of pure love tunes.

Rafael Vasquez
12midnight - 6am
"Late Night with Chico Suave" brings high energy to keep the late night audience awake and dancing.

Elias Conde
10am - 3pm
Elias' smooth voice and infectious good humor keep the audience moving through the day and glued to La Z. On a regular basis Elias has live interviews with established and up-and-coming recording artists.

Talent and format are Z advantage.

Z Spanish Hit Radio is a music intensive format developed by R&M award winning Program Director Salvador Homero Campos. This format can best be described as a blend of three established radio formats: Contemporary Hit Radio (CHR), Contemporary Country (Banda/Ranchera), and Top 40/Dance. "La Z's" unique sound comes from the lively danceable tunes mixed with the quick and witty style of our radio personalities. The tight DJ interventions, and heavy rotation of new releases appeals to everyone from 12+, but the bulk of our audience is in the primary demographics of 18-49.



Z-Spanish is bringing nationally renowned Spanish language talent and programming to small, medium, and large markets. The "open/interactive" nature of the network serves to unify these markets through our 800-Toll free line. La Z listeners feel they are part of something bigger where they can make requests or send greetings to friends and relatives across traditional radio boundaries.

"The network is designed to meet the need for a Spanish language 'Super Station' in the Western United States."

Z-Spanish was launched in November 1992 with stations in Sacramento, CA, Walnut Creek, CA, and Fresno, CA. All three FM's broadcast on 92.1 FM, giving this network core a regional presence unmatched by any other broadcast. Since 1992, the network has expanded and covers 7 distinct markets stretching from Washington to Arizona with 6 FMs and 4 AMs.

See representative contact information on back panel.

EXHIBIT B

A PLAN FOR THE DEVELOPMENT AND ACQUISITION OF BROADCAST STATIONS FOR THE LATINO COMMUNITY

Presented to the F.C.C. Conference on
Minority Broadcast Ownership
Washington, D.C.

April 26, 1977

By the National Task Force On
Latino Broadcast Ownership Of The
National Latino Media Coalition

Amador Bustos

Joseph M. Aguayo

STATEMENT:

The Latino population of the U.S. now stands at 23 million strong. The same group of 23 million now earns $30 billion per year and spends $27 billion on consumer goods primarily advertised through the media of TV, radio and newspapers -- as does most of the American public.

It is also noteworthy that the distribution of the Latino population corresponds with the top 50 TV, radio and newspaper markets of the nation -- thus, the Latino community is often a dominant market segment in leading market areas.

Of the 954 television stations in the U.S. as of mid-June of 1975, more than 100 provide some amount of Spanish-language programming. The Spanish International Network (Channel 41 in New Jersey) and its almost eleven affiliate stations provide mostly Spanish language programming produced in Mexico for syndication through Central and South American including Puerto Rico.

In terms of the radio market, more than 200 stations broadcast in Spanish with programming for at least 30 hours per week. The number one radio and TV market of New York City has at least two stations with 24 hours and 18 hours of only Spanish-language programming.

Given this scope of population and buying power, the extent of Latino ownership and management of broadcast stations poses a national scandal. Presently, only six television

stations are owned and operated by Spanish-speaking interests, with two new additional licensees pending.

The National Latino Media Coalition has, at its Fifth Annual Conference in New York City, constituted a National Task Force on Latino Broadcast Ownership, and proposes to the Federal Communications Commission, the following recommendations which, if accepted by the FCC, should be sent to President Carter and also the various federal agencies indicated:

I. FINANCING OF LATINO BROADCAST VENTURES

A. That the Small Business Administration's present policy of disallowing loans and loan guarantees for broadcasting be changed by either administrative correction or legislative amendment. The SBA should be empowered to provide specific set-asides for minority broadcast ownership.

B. That the Corporation for Public Broadcasting provide radio start-up monies for Latino ownership as well as sufficient monies from its community service grants and minority training grants for the training of Latino broadcast personnel and the hiring of professional staff.

C. That the Educational Broadcast Facilities Division of the Office of Education specifically set a priority of funds for the purchase of broadcast facilities for potential Latino and other minority entrepreneurs.

II. FEDERAL COMMUNCIATIONS COMMISSION

A. That the FCC commit itself to both VHF and UHF drop-in frequencies and channels for specific use and ownership by Latino owners in key Latino markets.

B. That the FCC allow for public access to its computer data on frequency allocations as to selected Latino markets, as well as existing financial, and other station market data as contained. It is likewise recommended that the FCC's Office of Consumer Affairs be assigned to handle this responsibility.

C. That the FCC give public priority to both pending and future licensing applications by Latino and other minority owners.

D. That the FCC streamline and give priority status to the processing of licensing application from Latino owners and other minority groups.

E. That the FCC should immediately undertake to hire Latino professionals in its various divisions who will be able to respond and handle licensing and other applications with adequate care and sensitivity.

The National Task Force on Latino Broadcast Ownership of the NLMC recognizes the leadership commitment of the Federal Communications Commission in the broadcasting field and recommends that a similar conference on Minority Ownership of Cable Broadcast Media be convened in the immediate future.

The National Latino Media Coalition commends the FCC on its unprecedented conference on Minority Ownership in the Broadcasting Field and urges the FCC to exercise its commitment on those federal agencies (SBA, Corporation for Public Broadcasting, Office of Education, etc.) to ensure that the above-mentioned areas are issues and resources realized.

Mr. HANCOCK. Thank you, Mr. Bustos.
Mr. Montero.

STATEMENT OF FRANCISCO R. MONTERO, COUNSEL, AMERICAN HISPANIC-OWNED RADIO ASSOCIATION AND RADIO BROADCASTERS ASSOCIATION OF PUERTO RICO

Mr. MONTERO. Yes, that is correct. Thank you, Congressman Hancock. I know I am the caboose on this train, so I will try to keep it short.

My name is Francisco R. Montero and I am a communications attorney and a partner with the law firm of Fisher, Wayland, Cooper, Leader & Zaragoza, and I represent, among others, the American Hispanic-Owned Radio Association, which is a nonprofit trade association made up of Hispanic-owned commercial radio stations. I also represent the Radio Broadcaster's Association of Puerto Rico and also counsel members of the Hispanic National Religious Broadcasters.

My comments will focus on the difficulty minority-owned broadcasters face in gaining entrance to the broadcasting industry. I will save a rehash of what section 1071 says. I think we are all pretty familiar with it now. However, in applying that section to the FCC's policies of diversity, localism and minority participation in broadcasting, I think the FCC reasonably exercised discretion. As a means of promoting the FCC's policies, minority tax certificates are both cost effective and inexpensive to administer.

It is a bitter irony, I think, that one of the fastest growing segments of the population, that is Hispanic Americans, is one of the most underrepresented in the broadcasting industry. Yet because of the language barrier that they face, Hispanics are frequently most in need of effective media outlets.

The Hispanic population comprises approximately 9.9 percent of the U.S. population, and is expected to be the largest ethnic minority in the country by the turn of the century. Hispanics are culturally and politically diverse on both ends of the aisle; however, they stand united in their desire to participate in American society and commerce.

Also, they are united in that their countries of origin share a common tongue, and that is Spanish. It is estimated that 97 percent of Hispanic Americans speak at least some Spanish, and 51 percent speak it exclusively. This is a demographic which has not been lost on nonminority broadcasters. Two of the three national Spanish language radio chains are non-Hispanic owned; and the two major Spanish language television networks in the United States are not owned by Hispanics. MTV, CNN, HBO, NBC, and CBS have all formed Spanish language-programmed networks or channels, but Hispanics do not own these.

While Hispanic broadcasters admire and applaud the efforts of these non-Hispanic companies to serve the Hispanic community, there needs to be equal growth in the numbers of Hispanic broadcasters who understand and respond to the subtle issues affecting the Hispanic American community.

As the Hispanic population of the United States has grown, so has the spread of Spanish-speaking communities in cities and States which have not previously seen Hispanic populations. The

Hispanic populations of most American cities goes without printed news and information in Spanish, and must consequently rely on radio and television broadcasts for local news and information. It is the Hispanic broadcasters that usually serve this need. They are the ones that tell the Hispanic community in Spanish about which schools are closed during snow storms and where to go during national disasters.

Also, it should be noted that virtually all of the noncommercial Hispanic-owned radio and TV stations are programmed in Spanish, and they serve the educational and religious needs of the communities.

The minority tax certificate policy assists minorities to gain an ownership stake in the broadcasting industry and carries out the FCC's policy of promoting localism and diversity on the airwaves and, ultimately, benefits the tax base. Through ownership, these broadcasters have grown and provided employment to the Hispanic community. Thus, the benefits of the certificate trickle down throughout the community and the marketplace.

I was going to cite a graphic example, an anecdotal example of the benefits of the tax certificate, but I think Amador Bustos and Raul Alarcon and several of the others on the panels this morning are shining testaments of the success stories created by the FCC's tax certificate policy.

Often Hispanics, like other minority groups, do not have the track record to obtain the financial backing to outbid nonminority broadcasters in the open market. Capital and financing are extremely difficult to come by. The large nonminority-owned broadcasters have the credit and collateral to outbid the minority broadcasters. Without the existence of the minority tax certificate program, many successful Hispanic broadcasters would not have had the opportunity to compete with the larger, better financed, nonminority-owned broadcasters to acquire their first station.

As a final matter, there is another interesting point here with Hispanic broadcasters. It should be noted that Hispanic American broadcasters face some of their fiercest competition from Latin America. Mexican stations reach Texas, New Mexico, and California. Dominican stations reach Florida, Puerto Rico, and the U.S. Virgin Islands. These stations are not subject to the stringent Federal regulations that Hispanic American broadcasters face. Also, they usually undercut Hispanic American broadcasters in their advertising rates because of reduced overhead costs.

It is tragic that several State governments actually advertise with Mexican stations because they are cheaper to reach the Hispanic population in the United States than buying time on stations owned by Hispanic Americans. Programs like the tax certificate help stem that tide. The program helps Hispanic Americans enter the market so that they can compete and serve as a growing and productive segment of the American society, and this in turn helps keep American advertising dollars in the United States where they belong.

For these reasons, the FCC's tax certificate policy should be preserved and endorsed. I am available to answer any questions if you have any. Thank you.

[The prepared statement follows:]

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January 27, 1995

Testimony of Francisco R. Montero
Counsel to the American Hispanic Owned Radio Association
and the Radio Broadcasters Association of Puerto Rico
before The Subcommittee on Oversight
of the Committee on Ways and Means
Presiding Congresswoman Nancy L. Johnson (R-CT)

Good morning Ladies and Gentlemen. My name is Francisco R. Montero. I am a communications attorney and partner with the Washington law firm of Fisher Wayland Cooper Leader & Zaragoza L.L.P. My primary practice area involves the representation of Hispanic broadcasters before the Federal Communications Commission. I represent the American Hispanic Owned Radio Association ("AHORA"), a non-profit trade association made up of Hispanic owned commercial radio stations, as well as the Radio Broadcasters Association of Puerto Rico. Also, I have counseled members of the Hispanic National Religious Broadcasters.

My comments will focus on the difficulty minority owned broadcasters face in gaining entrance to the broadcasting industry. Congress gave the FCC wide discretion in the implementation of Section 1071 of the Internal Revenue Code. The Section provides that the FCC may issue a tax certificate that permits sellers of broadcast properties to defer capital gains taxation on a sale or exchange of property whenever it determines that such a sale or exchange is "necessary or appropriate to effectuate a change in a policy of, or the adoption of a new policy by the Commission with respect to the ownership and control of radio broadcasting stations..." The minority tax certificate policy is consistent with the original intent of Section 1071. In applying Section 1071 to promoting the FCC's policies of diversity, localism, and minority participation in broadcasting, the Commission reasonably exercised its discretion with Congressional endorsement. As a means of promoting the Commission's policies, minority tax certificates are both cost effective and inexpensive to administer. The policy should, therefore, remain intact. Moreover, it should be noted that the FCC has initiated a rulemaking proceeding regarding its minority tax certificate policy. Comments and reply comments on the Commission's rulemaking proceeding are due on April 17 and May 7, respectively. As such, the Congress should consider the comments that are filed in that proceeding.

It is a bitter irony that one of the fastest growing segments of the population, Hispanic Americans, is one of the most under-represented in the broadcasting industry. Yet, because of the language barrier they face, Hispanics are frequently most in need of effective media outlets. The Hispanic population comprises approximately 9.9% of the U.S. population, and is expected to be the largest ethnic minority in the country by the turn of the century. Hispanics are culturally and politically diverse. However, they stand united in their desire to participate in American society and commerce. Also, they are united in that their countries of origin share a common tongue,

Spanish. It is estimated that 97% of Hispanic Americans speak at least some Spanish and approximately 51% speak it exclusively.

This is a demographic which has not been lost on non-minority broadcasters. Two of the three national Spanish language radio chains are non-Hispanic owned. The two major Spanish language television networks in the United States are not owned by Hispanics. MTV, CNN, HBO, NBC, CBS have all formed Spanish language programmed networks or channels. None are Hispanic owned. While Hispanic broadcasters admire and applaud the efforts of these non-Hispanic companies to serve the Hispanic community, there needs to be equal growth in the numbers of Hispanic broadcasters who understand and respond to the subtle issues effecting the Hispanic American community. The greatest obstacle Hispanics face in entering the broadcasting industry is a lack of capital which makes it nearly impossible to enter into and grow in the market. This reality has been recognized by various Federal, state, and local efforts to help Hispanics and other minority groups gain access to vital news and public service information in Spanish.

As the Hispanic population of the U.S. has grown, so has the spread of Hispanic communities in cities and states which were not previously known for their Hispanic populations. Cities like New York, Los Angeles, Miami, Chicago and Washington are known to have very large Hispanic populations. However, we are seeing the growth of Hispanic communities in cities such as Portland, New Haven, Nashville, Oklahoma City, and Salt Lake City to name a few. Unlike many other minority populations in the country, however, the Hispanic community faces a real obstacle in gaining access to local news and information in the Spanish language. The existence of local Spanish language media outlets to provide local news, weather and information in Spanish is essential.

The only cities in the country with regular Spanish language newspapers are the largest metropolitan areas with major Hispanic populations. As such, the growing Hispanic population of most American cities go without printed news and information and must, consequently, rely on radio and television broadcasts for local news and information. It is the small Hispanic broadcasters that usually serve this need. In fact, most Hispanic broadcasters program their stations in Spanish. They usually own their station in their home town and frequently serve as their own general manager. It is the small Hispanic broadcaster who will tell the Hispanic community in Spanish about which schools are closed during a snow storm or where to go during a natural disaster. While there are national Spanish language broadcasting chains, very few provide local news and information and only one is Hispanic owned.

The minority tax certificate policy assists minorities to gain an ownership stake in the broadcasting industry and carries out the FCC's policy of promoting localism and diversity on the airwaves, and ultimately benefits the tax base. Over the past five years, there have been over a dozen instances in which Hispanic Americans have used the tax certificate policy to help them acquire a station. Through ownership, these broadcasters have grown and provided employment to the Hispanic community. Likewise, they have provided an advertising outlet for other local businesses which serve the Hispanic community. These businesses have, in turn, grown. Finally, because of the limitations placed on minority tax certificates, the purchase price paid for the station is usually reinvested into the country's communications infrastructure. In short, the policy helps minority businesses succeed, serves the community and generates tax revenues. Thus, the benefits of the certificate trickle down throughout the community and the marketplace.

A graphic example of the benefits of the tax certificate policy involves a client of mine who acquired his first AM station in Laredo in 1990. He is from Laredo and still lives in Laredo. Because he could offer the previous owner a tax

certificate, he was able to lower his bid and, thus, afford to buy the station. He is an Hispanic American and he programs the station in Spanish. He is the general manager of the station and his mother answers the telephone. His station was such a success that in 1993 he bought an FM station in Laredo which he also programs in Spanish. Most recently he has acquired an interest in an AM station near San Antonio which is also programmed in Spanish. Without the assistance he received from the tax certificate program, he would never have been able to afford the first station, and the industry would have lost a successful, tax paying participant.

The FCC has long recognized the need and value of encouraging diversity and localism as strong public policy objectives. In furtherance of this policy, the FCC has long recognized the need and value of encouraging Hispanic and other minority ownership in broadcast facilities. However, minority broadcasters have continually faced obstacles in obtaining the necessary financial assistance to compete. The fact that non-Hispanic broadcasters are entering the Spanish language broadcasting market to the virtual exclusion of Hispanics is testimony to the problem. Often, Hispanics, like other minority groups, do not have the track record to obtain the financial backing to out-bid non-minority purchasers in the open market. Capital and financing are extremely difficult to come by. The large non-minority owned broadcasters have the credit and collateral to out-bid minority broadcasters. While the FCC is to be commended in its efforts to encourage minority ownership, without the existence of the minority tax certificate program, many successful Hispanic broadcasters would not have had the opportunity to compete with larger, better financed non-minority owned broadcasters to acquire their first station.

As a final matter, it should be noted that Hispanic American broadcasters face some of their fiercest competition from Latin America. Mexican stations reach Texas, New Mexico and California. Dominican stations reach Florida and Puerto Rico. These stations are not subject to the stringent Federal regulations that Hispanic American broadcasters face. Also, they usually undercut Hispanic broadcasters in their advertising rates because of reduced overhead costs. It is a sad example that the State of California purchases Spanish language advertising time from stations in Mexico to reach the Hispanic American communities in San Diego and other cities, frequently to the exclusion of Hispanic American broadcasters in those American cities. Thus, Hispanic American broadcasters, who serve this vital role of providing the Hispanic American community with local Spanish language news and information, are being beat out by Latin American competitors. Programs like the tax certificate policy help stem the tide. The policy helps Hispanic Americans enter the market so they can compete and serve this growing and productive segment of the American society. This, in turn, helps keep American advertising dollars in the United States where they belong. For these reasons, the FCC's tax certificate policy should be preserved and endorsed. I am, of course, available to provide any additional information that the Committee may request.

Mr. HANCOCK. Well, thank you very much for your testimony. That will become part of the record.

I would just like to make the statement that this hearing was not called for the express purpose of eliminating something that is beneficial to the economy and beneficial to minorities. And, it is not only to determine the justification for a specific situation that maybe should or maybe should not occur.

The testimony I have heard today, in my own opinion, has been very informative. I think this panel and the previous panels understand that we do have a problem which we are going to try to address. I think that is what the public expects of us under the Contract With America.

Your particular company, Mr. Oxendine, you are a venture capital company and you evidently also own three television stations. Are you into radio also or just television?

Mr. OXENDINE. I finance radio and I own TV.

Mr. HANCOCK. Is your Capital Fund incorporated? Is this a minority enterprise, also?

Mr. OXENDINE. Yes, it is. It was started by the broadcast industry. ABC, NBC, CBS, and 73 other broadcasters invested in the company. So it is called Broadcast Capital Fund. We went to the SBA and asked for a license. We have a MESBIC and we use that. So we took that, and in the last 14 years we have been lending to minorities.

Mr. HANCOCK. Broadcast Capital Fund is primarily funded by major——

Mr. OXENDINE. By the broadcasters.

Mr. HANCOCK.—broadcasters. Fine.

Mr. OXENDINE. It is a not-for-profit private initiative.

Mr. HANCOCK. Private venture capital?

Mr. OXENDINE. Yes.

Mr. HANCOCK. Do any of the witnesses have anything that you would like to add, briefly?

Mr. BUSTOS. Congressman Hancock, you keyed on a particular aspect that I also had cut out of my dissertation because it was a little bit longer, and that is the similarity to the capital gains tax.

The deferral is very closely—has the same effect of allowing that company to save to reinvest in another portion of the economy, or generally the communications industry as well, which will then produce jobs in that industry, which increases productivity and so forth. The whole cycle goes to productivity, to employment, and then to eventual taxation through tax or employment income taxes. So it does have a close parallel and since it is also a deferral and not a credit, I think it has even a healthier benefit.

Mr. OXENDINE. Congressman Hancock.

Mr. HANCOCK. Yes, sir.

Mr. OXENDINE. I just wanted to say something with regard to the FCC and we, as minorities. I think that it is important to understand that when we go before the FCC to ask about whether or not we qualify for a tax certificate, I think, Don Cornwell, you alluded to what his company does, but I think the FCC in making its comments to the subcommittee was kind of remiss in saying what they do, because they really are good electronic policemen policing the airwaves.

When you talk about the minority control issue before the FCC, you have to make the distinction between equity control and voting control. A limited partnership is one thing, and a regular corporation is another in terms of equity participation and voting control requirements.

The limited partnership mirrors a regular business. Regular business people come to an investor and say, "Look, I have an idea; I want to finance something. You put up 90 cents, I will put up 10 cents; let me have voting control and together we will make some money."

When we go before the FCC we are asked two things: Are you a minority-controlled organization? To be minority controlled, you have to have 51 percent of the voting stock of your company. That is not difficult to determine. The problem comes with regard to the amount of equity the minority provides. When you look at a limited partnership, you may have 10 limited partners who each put up $10 million. That is not what is important. You have a general partner corporation, which usually includes the minority interest, that is really important.

I think that what you have to look at and ask is: Does the minority really have 20 percent equity in the company? You can have a general partnership corporation of the limited partnership that has only $10,000 as the total equity. So any minority can find $2,000 or $2,100, which could qualify as 21 percent of the equity in the company, and then the majority would put up the balance of $8,000. The problem is that in that general partner corporation assignment, you could also have a preferred stock portion where someone could put up $5 million for an interest in the company.

So I think the question you might want to ask in the future when you examine minority-controlled organizations, is not only do you have voting control, but how does the equity that the minority contributes compare to the entire amount being funded.

I hope you do not pass a law that requires us to put up 51 percent of the equity in a deal. No one does that. The FCC, they have a notice of proposed rulemaking asking for comments from the public regarding minority initiatives. I think one requirement is that we as minorities should put up substantial equity, whatever that number is. I think, Don Cornwell, that is what you were talking about. There should also be some real management control for the minority group, as well as voting control.

The FCC should review the approval rights of the other investors. Too often, when you look at the underlying documents to a particular financing, you find out that the other partners have so much control you, as a minority, are not really in charge. The above are the issues that lots of folks have not looked at, and I think those are easy things to do. Ask some simple basic questions of minorities and their partners and you will find out what is a sham and what is real. The mechanism is there.

Ms. BRUNSON. I would like to bring to your attention the concept that we are costing the government, costing the consumer, costing the public money by using this deferral process. I would like to reemphasize that we are never costing the government if the leveraging of the funds and sale exponentially extends the growth to where you bring in five or six or seven times the impact of jobs

and revenue in terms of the economic base. In this way you are really using the mechanism to create for the consumer a much healthier economic environment.

So that when we start using terms where we are saying we are taking this money out of the pocket of America, we must also weigh the concurrent benefit that is being brought to the table by the expansion of these businesses by those of us who are given the opportunity to own a small property, and then put our 150 percent energy into growing those properties to a greater degree than the person who is spinning it off, who may not have the same intensity to do the kinds of things that we will do.

Not only do we bring an economic benefit to the whole process, but we bring an underlining benefit where we provide the training and the development for the next generation of broadcasters coming in so that they will have the wherewithal to be able to understand how to penetrate this medium so that we will have continuous voices of African-American owners and operators.

So I would like for us to look at the process of weighing that which we say we are taking away with that which is also being put on the table by the combined effort of those of us who grow these into much, much larger businesses than they were when we got the tax certificate in the first place.

Mr. HANCOCK. Well, Ms. Brunson as a small businessman before I came to the Congress, you may rest assured that I am familiar with what is called sweat equity. Very familiar with it.

Well, thanks again for your testimony, and this hearing is adjourned. Thank you.

[Whereupon, at 3:15 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

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February 7, 1995

Hand Delivery

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Re: Hearing to Examine the Operation and Administration of Code Section 1071, FCC Tax Certificate Policy

Dear Mr. Moseley:

We respectfully submit this written statement for the printed record of the January 27, 1995 hearing by the Subcommittee on Oversight of the Committee on Ways and Means ("Subcommittee") to examine the operation and administration of Section 1071 of the Internal Revenue Code of 1986, as amended ("Code"). In accordance with your instructions, six (6) copies are enclosed.

In view of the numerous comments received by the Subcommittee in connection with the hearing, we have not provided an overview of Code Section 1071.[1] Instead, we have assumed familiarity with the Code Section and will respond directly to the inquiries raised.

[1] For an excellent discussion of the mechanics of Code Section 1071, please see, Edward L. Glazer and Stephen D. Fisher, *Section 1071: FCC-Certified Transactions Involving Minority-Controlled Entities*, 47 Tax Law. 91 (1993).

McMANIMON & SCOTLAND

Phillip D. Moseley, Chief of Staff
Committee on Ways and Means
U.S. House of Representatives
February 7, 1995

THE FCC'S 1978 POLICY IS CONSISTENT WITH THE UNDERLYING INTENT OF CODE SECTION 1071

The 1978 Policy

On May 25, 1978, the Federal Communications Commission ("FCC") issued its *Statement of Policy on Minority Ownership of Broadcasting Facilities*, 68 F.C.C.2d 979 (1978) (hereinafter cited as the "*1978 Policy Statement*"). The expressed policy was "to increase significantly minority ownership of broadcast facilities." The ultimate goal of this policy was to increase programming diversity so that it more accurately reflected the viewpoints of all Americans. Ownership was preferred as a means of furthering program diversity because it does not require direct governmental intrusion into programming. This policy was consistent with several court decisions,[2] and its ideals are part of the 1934 Communications Act and inherent in the First Amendment.[3]

One of several steps the FCC selected to implement this policy was the use of its authority to grant tax certificates under Code Section 1071 in circumstances the FCC determined appropriate. *1978 Policy Statement*. Appropriate circumstances include those where a sale of media is proposed to parties with a significant minority ownership interest and where there is a substantial likelihood that diversity of programming will be increased.

The policy of using Code Section 1071 to enhance opportunities in the broadcasting industry was expanded to cable television systems in recognition of the technological revolution occurring in the communications and broadcast industries. In December 1982, in a *Policy Statement on Minority Ownership of Cable Television Facilities*, the FCC stated a new policy:

> "Believing that minority ownership of cable television systems is a significant additional means of fostering the inclusion of minority views in programming, and noting the relative scarcity of minority owned cable systems presently operating, the [Federal Communications] Commission adopts a policy of encouraging

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[2] *See, Citizens Communications Center v. F.C.C.*, 447 F.2d 1201 (D.C. Cir. 1971); *TV 9 Inc. v. F.C.C.*, 495 F.2d 929 (D.C. Cir. 1973).

[3] In the Communications Act of 1934, Congress assigned to the FCC exclusive authority to grant licenses, based on "public convenience, interest, or necessity," to persons wishing to construct and operate radio and television broadcast stations. 47 U.S.C. §§ 151, 301, 303, 307, 309 (1982 ed.).

> minority ownership of cable systems, utilizing the Commission's tax certificate authority as a form of subsidization of minority entrepreneurs seeking to enter the cable television market." 52 Rad. Reg. 2d (P & F) 1469 (1982).

The FCC acknowledged that "[T]he functions that cable television system operators perform for their subscribers are, to a large degree, similar to those performed by broadcast licensees for their respective audiences." Id. at 1470. The FCC also recognized that greater efforts were necessary to achieve the goal of diversified programming contemplated by the Communications Act of 1934, and stated, "despite our previous efforts to ensure program diversity, it appears that additional measures in the area of cable television are appropriate." Id. at 1471.

In September 1985, the FCC expanded the application of Code Section 1071 to include non-wireline cellular transfers. The FCC explained:

> "although cellular systems do not constitute "radio broadcasting stations" within the meaning of the [Communications] Act [of 1934], a broad reading of the language of the tax statute (Section 1071 of the Internal Revenue Code) is appropriate in light of the general congressional intent underlying the statute's passage and radical transformation of the telecommunication marketplace since the statute's adoption." *In re Telocator Network of America*, 58 Rad. Reg. 2d (P & F) 1443, 1448 (1986).

In responding to the technological innovations occurring in communications and broadcasting industries, the FCC held:

> "In light of the legislative intent of Section 1071, the dramatic changes in telecommunication marketplace since its original enactment and Commission precedent, we conclude that the phrase "radio broadcasting station" is illustrative of the more general congressional intent to facilitate the effectuation of the Commission's policies rather than restrictive, and the scope of the phrase is properly construed as expanding with the extension of the Commission's pro-competitive policies. Accordingly, we hold that the phrase does not bar the issuance of tax certificates in connection with transfers of non-wire cellular partnership interests in cellular markets 31 through 90." Id. at 1450.

Thus, in fulfilling its role in a rapidly evolving industry, the FCC would have been remiss if it had failed to allow its application of Code Section 1071 to evolve in a commensurate manner into the new telecommunications technologies.

McMANIMON & SCOTLAND

Phillip D. Moseley, Chief of Staff
Committee on Ways and Means
U.S. House of Representatives
February 7, 1995

Intent of Code Section 1071

Code Section 1071 was originally enacted in 1944 as Section 112(m) of the Internal Revenue Code of 1939 ("1939 Code"). Act of February 25, 1944, Ch. 63, Section 123(a), 58 Stat 40-43, 46. In Code Section 112(m), as originally enacted, Congress delegated to the FCC the authority to grant tax certificates as:

> " . . . necessary or appropriate to effectuate the policies of the Commission with respect to the ownership and control of radio broadcasting stations . . ." 1939 Code Section 112(m).

This section was passed to help the FCC implement a "new policy" that prohibited ownership of more than one radio station in a single market. Senate Finance Committee Report, 78th Cong., 1st Sess., S. Rept. 627 (1943). Congress intended it to provide relief for licensees who had to sell or exchange such stations as a condition of obtaining license renewal. Id. Congress did not specify any limits to this delegation of authority. Thereafter, the FCC exercised its broad regulatory authority to make and change policies concerning the ownership and control of broadcasting stations with the aid of tax certification.

Section 112(m) was recodified without material change as Section 1071 in the Internal Revenue Code of 1954. H. Rep. No. 1337, 83rd Cong., 2nd Sess., reprinted at 1954 U.S. Code Cong. & Ad. News 4621, 59072. However, the Senate Report accompanying the bill did specifically comment on the definition of "radio broadcasting":

> "The form of 'radio broadcasting' as used in the Bill and in the 1939 Code has an established meaning in the industry and in the administration of the Federal Communications Act which is sufficiently comprehensive to include telecasting." S. Rep. No. 1622, 83rd Cong., 2nd Sess., reprinted at 1954 U.S. Code Cong. & Ad. News 4261, 5072.

Clarifying language, in the form of a technical amendment, was substituted into Section 1071 in 1958. This amendment provided that tax certificates would be granted as "necessary or appropriate to effectuate a change in a policy of, or the adoption of a new policy, by the Commission." Technical Amendments Act of 1958, Pub. L. No. 85-866, § 48, 72 Stat. 1606, 1642 (1958); H.R. Rep. No. 775, 85th Cong., 1st Sess. 29 (1957). This change facilitated the FCC's usage of Section 1071 to implement evolving policies, such as that to increase the diversity of broadcast licensees.

Phillip D. Moseley, Chief of Staff
Committee on Ways and Means
U.S. House of Representatives
February 7, 1995

Consistency between 1978 Policy Statement and Code Section 1071

The intent underlying Code Section 1071, namely, to provide the FCC with a tool to effectuate its policies, is entirely consistent with the 1978 Policy Statement. Indeed, Code Section 1071 remains an essential tool at the disposal of the FCC in its attempts to increase minority ownership of broadcast facilities. It is difficult to conceive of many industries that have changed as significantly as the communications industry has over the last fifty years. The FCC would have been remiss if it had not expanded the scope of the tax certificate program to keep pace with the rapid developments in the communications industry.

Recently, attention has been focused on the size of the tax benefits expected to be granted under the tax certificate program. Certainly, it is quite difficult to quantify the social benefit derived from the tax certificate program in any meaningful way. To attempt to assess this benefit against a hypothetical tax cost is pointless. The magnitude of the transactions now being undertaken in the deployment of the National Information Infrastructure, however, are indicative of the importance of the communications industry in our society today. Now, more than ever, it is essential that the tax certificate program be endorsed to ensure universal access to telecom facilities. Code Section 1071 indisputably remains an essential tool in diversifying the ownership of broadcast licenses.

THE FCC'S ADMINISTRATION OF CODE SECTION 1071 DOES NOT CONSTITUTE AN IMPERMISSIBLE EXERCISE OF LEGISLATIVE AUTHORITY

The FCC's administration of Code Section 1071 constitutes a permissible exercise of legislative authority. This has been examined by academics, the courts and by Congress on more than one occasion. In each case, the conclusion reached is that it is a legitimate exercise of legislative authority.

Court Decisions

Prior to the 1978 policy, the Review Board, in an opinion accepted by the FCC, had taken the view that the "Communications Act, like the Constitution, is color blind." *Mid-Florida Television Corp.*, 33 F.C.C 2d 1, 17 (Rev. Bd.), *aff'd*, 37 F.C.C.2d 559. The issue of what the FCC should consider in awarding broadcasting licenses arose in *TV 9, Inc. v. FCC*, 495 F.2d 929

(D.C. Cir. 1973), *cert. denied*, 419 U.S. 986 (1974). In *TV 9*, the FCC, in awarding a license, gave little weight to the fact that the losing applicant was minority-owned. In considering the reasoning of the FCC, the appeals court stated:

> "To say that the Communications Act, like the Constitution, is color blind, does not fully describe the breadth of the public interest criterion embodied in the [Communications] Act. Color blindness in the protection of the rights of individuals under the law does not foreclose consideration of stock ownership by members of a Black minority where the [Federal Communications] Commission is comparing qualifications of applicants for broadcasting rights . . ." *Id.* at 936.

Similarly, the same court, in *West Michigan Broadcasting Co. v. FCC*, 735 F.2d 601 (D.C. Cir. 1984), *cert. denied*, 470 U.S. 1027 (1985), considered a situation in which two companies filed mutually exclusive applications to build a new FM radio station in Michigan. One of the companies was owned by a minority who would fully participate in the station's management. In that case, the appeals court held that the FCC could give merit to a minority applicant regardless of whether there was a substantial minority-group population in the city where the license was located. *Id.* at 609. Further, increased media ownership by minorities, the court decided, should conclusively be presumed to advance the public interest. *Id.*

More recently, the Supreme Court upheld the constitutionality of two policies that enhance the opportunities for minorities to acquire FCC licenses. *Metro Broadcasting, Inc. v. F.C.C.*, 110 S. Ct. 2997 (1990). In evaluating two related FCC policies to increase minority ownership, the Supreme Court consolidated *Metro* with *Astroline Communications Company Limited Partnerships et al. v. Shurberg Broadcasting of Hartford, Inc. et al.* The policies in question were 1) the FCC program of awarding enhancement for minority ownership in comparative proceedings for new licenses; and 2) the distress sale program permitting a limited category of existing radio and television stations to be transferred only to minority-controlled firms.

In finding both FCC policies constitutional, the Supreme Court held that minority ownership programs had been specifically approved and mandated by the Congress, and as such required judicial deference. *Id.* at 3008. Additionally, FCC minority ownership policies promote programming diversity. *Id.* at 3009, 3010. Further, programming diversity serves important First Amendment values, and remains consistent with the 1934 Communications Act. *Id.* at 3010, 3012.

Congressional Action

As part of Section 115 of the Communications Amendments Act of 1982, Congress authorized the FCC to choose by lottery among competing qualified applicants for certain licenses as an alternative to lengthy comparative proceedings. Pub. L. No. 97-259, § 115, 96 Stat. 1087, 1094-95 (codified at 47 U.S.C. § 309(i) (1982). Nevertheless, Congress required that:

> "significant preferences will be granted to applicants or groups of applicants, the grant to which of the license or permit would increase the diversification of ownership of the media of mass communications. To further diversify the ownership of the media of mass communications, an additional significant preference shall be granted to any applicant controlled by a member or members of a minority group." *Id.*

The legislative history of this provision acknowledges the FCC's continuing minority ownership policy and diversity of viewpoint rationale, and clearly shows that Congress intended to ensure that a similar minority preference was applied in any random selection licensing system. H. Conf. Rep. No. 765, 97th Cong., 2d Sess., 40, reprinted in 1982 U.S. Code Cong. & Admin. News 2261, 2284.

Since 1987, using appropriations legislation, Congress has prohibited the FCC from using any of its appropriated funds to repeal, retroactively apply changes in, or to reexamine any of its race or gender preference programs. Act of Dec. 22, 1987, Pub. L. No. 100-202, 101 Stat. 1329. This prohibition applies to the tax certificate, distress sale, and comparative licensing programs, respectively. *Id.* The limitation did not prevent an expansion of the programs. Thus, Congress has answered the statutory authority question by effectively ratifying the Commission's interpretation of the public interest standard and adopting a legal presumption that minority ownership produces more diverse programming that better serves the public interest.[4]

There can be no question that the FCC's administration of Code Section 1071 is a permissible exercise of legislative authority. Notwithstanding the judicial decisions and Congressional action, it is disturbing that questions are now being raised by the Subcommittee about the legislative authority to administer a Code section that has been in force and effect for more than fifty years.

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[4] In Comment, *FCC Tax Certificates For Minority Ownership of Broadcast Facilities: A Critical Re-examination of Policy*, 138 U. Pa. L. Rev. 979 (1990), the author correctly concludes that the FCC's administration of the program is within its statutory authority. *Id.* at 999.

McMANIMON & SCOTLAND

Phillip D. Moseley, Chief of Staff
Committee on Ways and Means
U.S. House of Representatives
February 7, 1995

THE TAX INCENTIVE PROVIDED IN CODE SECTION 1071 IN FACT FOSTERS MINORITY OWNERSHIP OF BROADCAST FACILITIES

In our experience as counsel to clients engaged in the broadcasting and communications industry, we emphatically affirm that the tax certificate program has provided opportunities for minority individuals to participate in the broadcasting and communications industries. Moreover, it has served to spark investment in the entire telecommunications industry. In examining the effectiveness of the program, it is noteworthy that the National Telecommunications and Information Administration reported that minorities held .5% of broadcast licenses in 1978, and as of 1994 held 2.9% of them. See, National Telecommunications and Information Administration, United States Department of Commerce, *Analysis and Compilation Minority-Owned Commercial Broadcast Stations*, 1994. Also, the FCC has reported that 378 tax certificates were issued for broadcast stations and cable television facilities from 1978 to 1994.

THE FCC POLICY IS A NECESSARY OR APPROPRIATE MEANS OF ACHIEVING THIS GOAL

The 1978 Policy remains as important today as it was in 1978, if not more so. While there have been significant improvements in minority ownership of broadcasting facilities and greater diversity in programming over the past sixteen years, there is still a long way to go. *See, Metro, supra at 3003-05.* The tax certificate program is one of several effective measures in achieving the FCC's policy objectives and as such should not be repealed or replaced.

The tax certificate policy permits more broadcast and cable properties to reach their highest valued use, thereby creating jobs and generating investment and tax revenues. The policy's reinvestment feature retains capital in the media industries, where it helps build the nationa's growing communications infrastructure. Furthermore, the policy helps small businesses enter the competitive marketplace and ultimately become large taxpayers themselves.

The FCC, working closely with the IRS, possesses the expertise to review and improve upon the tax certificate policy. The FCC is obtaining public comment on the policy, with comments due on April 17, 1995. Among the matters the FCC might consider are the need for additional data on the policy's long and short range tax consequences, the optimal holding period for facilities obtained under the policy, and procedures for additional scrutiny of the bonafides of tax certificate applicants. Congress should defer additional action on this matter until it receives the FCC's report and order.

IRS BUDGET PROPOSAL FOR FISCAL YEAR 1996 AND 1995 TAX RETURN FILING SEASON

HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

OF THE

COMMITTEE ON WAYS AND MEANS HOUSE OF REPRESENTATIVES

ONE HUNDRED FOURTH CONGRESS

FIRST SESSION

FEBRUARY 27, 1995

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IRS BUDGET PROPOSAL FOR FISCAL YEAR 1996 AND 1995 TAX RETURN FILING SEASON

MONDAY, FEBRUARY 27, 1995

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT,
Washington, D.C.

The subcommittee met, pursuant to call, at 10:05 a.m., in room B-318, Rayburn House Office Building, Hon. Nancy L. Johnson (chairman of the subcommittee) presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON OVERSIGHT

FOR IMMEDIATE RELEASE
February 15, 1995
No. OV-3

CONTACT: (202) 225-7601

JOHNSON ANNOUNCES HEARING ON INTERNAL REVENUE SERVICE BUDGET PROPOSAL FOR FISCAL YEAR 1996 AND 1995 TAX RETURN FILING SEASON

Congresswoman Nancy L. Johnson (R-CT), Chairman of the Subcommittee on Oversight of the Committee on Ways and Means, today announced that the Subcommittee will conduct a hearing on the Internal Revenue Services's budget proposal for fiscal year 1996 and the 1995 tax return filing season. **The hearing will be held on Monday, February 27, 1995, in room B-318 Rayburn House Office Building, beginning at 10:00 a.m.**

This hearing will feature invited witnesses only. In view of the limited time available to hear witnesses, the Subcommittee will not be able to accommodate requests to testify other than from those who are invited. Those persons and organizations not scheduled for an oral appearance are welcome to submit written statements for the record of the hearing.

BACKGROUND:

The fiscal year 1996 budget request for the Internal Revenue Service totals $8.2 billion and will support the activities of almost 115,000 employees. These resources will support the IRS's operations in collecting nearly $1.3 trillion in revenue and in administering the federal tax laws. The $8.2 billion budget request includes $830 million to process the tax returns which taxpayers will file in 1996; $1.6 billion to examine tax returns; $909 million for collection activities; and $1.9 billion for information systems.

The 1995 tax return filing season refers to the period of time between January and April 15th when American taxpayers are expected to file 116 million tax returns. Approximately 82 million taxpayers are expected to receive an average refund of over $1,100 in 1995.

The Subcommittee on Oversight held two hearings last year on the subject of income tax refund fraud. The Subcommittee learned that criminals were exploiting the tax system to receive fraudulent refund payments from the IRS. Two factors appear to have fueled a rapid expansion of refund fraud schemes. First, the refundable nature of some tax credits, such as the earned income tax credit (EITC), make them particularly susceptible to refund fraud. The U.S. General Accounting Office has said that the EITC is a factor in over 90 percent of fraudulent refund claims. Second, the advent of the electronic filing of tax returns has led some tax return preparers and banks to provide what are generally called "refund anticipation loans" (RALs) to taxpayers who file electronically. With RALs, banks lend money to a taxpayer based on his or her anticipated tax refund and not on the credit worthiness of the person as a borrower. Criminals sometimes can exploit the rapid turn-around time of a RAL to receive a refund before the IRS can complete its cross-checks and identify a fraudulent refund claim. At an October 6, 1994, Subcommittee hearing, Ronald K. Noble, the Under Secretary for Enforcement at the Department of the Treasury, testified that the refund fraud problem could be as high as $5 billion.

The Adminstration has taken several steps to curb income tax refund fraud during the 1995 filing season.

In October 1994, the IRS announced that it would suspend the issuance of direct deposit indicators (DDIs) to tax return preparers who file returns electronically. The DDI informs the tax return preparer that the taxpayer's refund is not subject to offset for delinquent government loans or child support. In the past, the receipt of a clean DDI often was a pre-condition for a bank to issue a refund anticipation loan.

The IRS also has increased its scrutiny of EITC claims. In particular, it is performing extensive cross-checks of all names and social security numbers to determine whether or not they match. A taxpayer's failure to supply accurate social security numbers could result in a delay of the person's tax refund.

DISCUSSION:

The IRS fiscal year 1996 budget request represents an increase of 888 employees and $726 million over the comparable levels in fiscal year 1995. The Subcommittee will review how these resources will be applied to carry out the mission of the IRS. In particular, it will review the status of the Tax System Modernization (TSM) program which is earmarked to receive over $1 billion in fiscal year 1996. TSM is the program to upgrade the computer and information handling capability of the IRS.

The Subcommittee also will review the staus of the 1995 tax return filing season. Special attention will be paid to the steps which the IRS is taking to curb refund fraud. It will review the consequences of the decision to suspend the issuance of DDIs and the closer scrutiny of EITC claims. It also will examine ways to reform the EITC to reduce fraud.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Any person or organization wishing to submit a written statement for the printed record of the hearing should submit at least six (6) copies of their statement by the close of business, Monday, March 13, 1995, to Phillip D. Moseley, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements wish to have their statements distributed to the press and interested public at the hearing, they may deliver 200 additional copies for this purpose to the Subcommittee on Oversight office, room 1136 Longworth House Office Building, at least one hour before the hearing begins.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. A witness appearing at a public hearing, or submitting a statement for the record of a public hearing, or submitting written comments in response to a published request for comments by the Committee, must include on his statement or submission a list of all clients, persons, or organizations on whose behalf the witness appears.

4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and the public during the course of a public hearing may be submitted in other forms.

Note: All Committee advisories and news releases are now available over the Internet at GOPHER.HOUSE.GOV, under 'HOUSE COMMITTEE INFORMATION'.

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Chairman JOHNSON. Good morning, Commissioner, and welcome everyone to this morning's hearing on the fiscal year 1996 budget proposal for the IRS (Internal Revenue Service), and on the 1995 tax return filing season.

The size of the budget increase sought this year is noteworthy. The budget will move from $8.2 billion and almost 115,000 employees to collect $1.3 trillion in revenue to a 10-percent dollar increase and a 922-person increase in the work force.

The size of the increase is noteworthy for several reasons: First, the increase is much larger than the inflation rate. Therefore, the budget proposal goes far beyond keeping pace with inflation and, instead, contains real growth in spending.

Second, the increase in the work force comes at a time when the overall Federal work force is undergoing a major downsizing. The fact that the IRS budget runs counter to the prevailing trend in Federal budgeting is no accident, but the expression "it takes money to make money" applies to the IRS as it applies to the business world.

This morning we want to learn how the IRS intends to use its resources in fiscal year 1996. Most IRS programs show only small changes but a few programs have significant increases. The budget proposal proposes a $441 million, or a 67-percent increase in the TSM (tax systems modernization) program.

The modernization program is supposed to upgrade and expand the IRS' computer and information handling capability. While it is absolutely essential to do so, it is important to understand the enormity of the challenge that the IRS faces year after year. Without this modernization program, it would certainly be crushed by the burden of processing over 1 billion documents every year.

Something I read mentioned that if you put the documents the IRS processes end to end you could circle the globe 36 times. It is a powerful amount of paper that has to be processed accurately, and so, Commissioner, we are very interested in the tax systems modernization program and in the progress you are making, as well as the problems you are encountering. Unfortunately, it is one of those programs that must be done, but a small mistake, as in the space program or other complex programs, could also have catastrophic consequences.

Second, the 1995 tax return filing season is now well under way and one major feature of this year's filing season is the activity of the IRS to curb fraudulent refund returns. The administration's testimony before the subcommittee in October 1994 revealed that refund fraud could be a $5 billion problem. We could fund most of the IRS' budget out of money the government is currently failing to collect.

Furthermore, a lot of the refund fraud is associated with the electronic filing program. In addition to the fact that 43 percent of the fraud is associated with electronic refunds, as I understand it, a large percentage of that fraud is associated with the EITC (earned income tax credit). It is important for this subcommittee to understand, because refundable tax credits are apparently turning out to be much more vulnerable to fraud than other kinds of taxes. With a number of refundable credits before us, this hearing today

is not only relevant to the IRS' efforts to curb this fraud but also to decisions that we might make in coming weeks.

The action to delay refunds for 16 percent of the tax returns, that is one out of every six returns, has created some problems and we will get into those problems today.

Commissioner, with you and later in the hearing with those affected by them, we hope to understand the problems that have been created by your antifraud efforts and look at whether there are any ways that we could alleviate some of those problems as well as understand fully the rationale for your actions.

I welcome you, Commissioner Richardson. It is a pleasure to have you and your staff before us, and I yield to my colleague, Mr. Matsui, the ranking member of this subcommittee, for an opening statement.

Mr. MATSUI. Thank you very much, Madam Chairwoman.

I want to endorse the statements that you made in your opening comments. I would like to just make a couple observations, some are redundant from what you have indicated.

The IRS is asking for a budget increase of $739 million from the last fiscal year, and that would include a 922-person increase in employment. I think, as you said, however, that whenever the IRS seeks additional funds, it is usually to increase collections, and so certainly we will support an effort such as that.

In addition, we have the tax systems modernization program that the Commissioner has been pursuing for several years. This is something that I support. One issue I think that we need to resolve, however, is just what kind of savings we will see out of this. The service says approximately $9 billion will be achieved over a period of 5 years, and the GAO (General Accounting Office), who we will be hearing from today, has indicated that they are not able to make that determination. We need to find out about what we will actually save.

Of course the third area, I think, is the area of fraud. I think the earned income tax credit and others have created some problems, and I think the Service is attempting to deal with those.

With that, I would also like to tell the Commissioner that we look forward to hearing her testimony and of course working with her throughout this tax filing period and throughout the year. Thank you.

Chairman JOHNSON. Do other members of the subcommittee wish to make opening statements?

Commissioner.

STATEMENT OF HON. MARGARET MILNER RICHARDSON, COMMISSIONER, INTERNAL REVENUE SERVICE, ACCOMPANIED BY MIKE DOLAN, DEPUTY COMMISSIONER; LARRY WESTFALL, MODERNIZATION EXECUTIVE; PHIL BRAND, CHIEF COMPLIANCE OFFICER; BOB WENZEL, CHIEF STRATEGIC PLANNING AND COMMUNICATIONS; AND JUDY VAN ALFEN, CHIEF TAXPAYER SERVICE

Ms. RICHARDSON. Thank you, Madam Chairwoman, and other distinguished members of this subcommittee.

I would like to introduce the people who are with me today. Mike Dolan, who is the Deputy Commissioner is on my right, your left;

Larry Westfall, who is the modernization executive for the Internal Revenue Service and in charge of the TSM program; I also have with me Judy Van Alfen, the chief, taxpayer service; Phil Brand, who is our chief compliance officer; and Bob Wenzel, who is the chief, strategic planning and communications.

We really do appreciate the opportunity to be here today to talk about our 1996 budget request and also the 1995 filing season.

I believe that the United States currently has the best tax administration in the world, but we at the Internal Revenue Service do recognize we can no longer do business as usual. We believe that American taxpayers have a right to fair and efficient tax administration from a customer service-oriented organization. For that reason, we feel we must be able to take advantage of technology and business system innovation to collect the revenue owed at the least possible cost and with as little burden as possible for taxpayers. The challenges that face us today—a growing population, rapid changes in technology, a global economy, and increasing sophistication in business practices—require innovative and creative approaches to achieve efficient and effective tax administration.

Fiscal year 1996 is a pivotal year for us. Our fiscal year 1996 appropriation will not only shape the agency's future, but, in my opinion, it will affect the quality and the effectiveness of tax administration in this country for many years to come.

Madam Chairman, this morning, I would like to give you and your colleagues a sense of the range of our business and what we are doing to operate more effectively and efficiently today and on into the next century. The progress toward a more effective tax administration system today, however, including the steps that we took to get ready for the 1995 filing season, will pale in comparison to the potential the tax systems modernization program will offer us when it is completed in a timely fashion.

In a few minutes, I am going to ask Mr. Westfall to talk to you a little more about our tax systems modernization program, but before he does, I would like to tell you a little bit about how we accomplish our mission today, and also our plans for accomplishing our mission in the year 2001.

I often say that the IRS is like a large multinational corporation—and we are larger than all but a handful of corporations—and like other large multinationals, we engage in many lines of work in order to accomplish our mission. We are in the financial services business—like a bank or a credit card company—but unlike most banks and credit card companies, we have to maintain and service approximately 200 million taxpayer accounts. We respond to taxpayers' account questions, we adjust accounts, we send out bills, and we process payments. We also process tax returns and payments.

For instance, during this filing season, during 1995, we will process approximately 1.1 billion information documents and approximately 208 million returns. Our gross receipts, if you will, are close to over $1.2 trillion. To accomplish the monumental processing task, we currently use an assembly line-like process.

Today, processing takes place at 10 service centers and 2 computing centers, and, during the height of the filing season, we work

round-the-clock, 7-day-a-week shifts. In those days just before and right after April 15, mountains of mail arrive at our service centers brought by convoys of tractor trailers.

Between 1986 and 1994, the number of tax returns filed increased by almost 15 million, while the staff processing these returns decreased—a real productivity improvement of 12.6 percent during that 8-year period. The result of this focus on productivity is that our 10 service centers today are currently operating at virtually their maximum levels of efficiency and quality within the limits of the current system. There is little or no further room for productivity increases at the service centers without technological enhancements.

TSM has already begun to help us meet the increased demands on our other burdened infrastructure by providing alternative methods of filing and receiving tax returns and payments. Today, a paper return must travel by mail to the service center, be processed through our mailroom, transported to a data entry clerk, and then keypunched into the system. This process is not only outdated and labor intensive, but it is also proned to errors by both taxpayers and by the Internal Revenue Service.

In contrast, nearly 16 million electronically filed documents, including 14,000,000 individual tax returns, bypassed these costly and inefficient steps last year. As a result, these electronically filed documents were processed with an accuracy rate of 99.5 percent, significantly higher than the accuracy rate for paper returns. Errors, by both IRS and taxpayers, represent rework at a significant cost and burden to the Service and possible cost and burden to taxpayers if we have to contact them in order to correct the errors.

By changing the way we do business through increased productivity and various alternative electric filing methods, we are already processing some tax returns and payments more efficiently. Although we are making significant progress by modernizing the way we conduct our business, we do need your continued support to completely transform our sixties assembly line processing operation into an automated, efficient operation worthy of the 21st century. Funding for our fiscal year 1996 budget request will help to ensure that the TSM program is completed in a timely fashion.

Another way we are changing the way we do business is by finding new and better ways to interact with taxpayers. Recognizing that correspondence is labor intensive, costly, and burdensome, the IRS has focused on making significant, meaningful improvements to our telephone operations. We do believe that taxpayers should be able to get through to the IRS on the first call and they should be able to have their issues resolved on that call.

To improve the way we interact with taxpayers, we have studied and are implementing some of the best practices of private industry. For example, today we can now transfer telephone traffic among 27 sites nationwide that helps us balance our workload and maximize the service availability to taxpayers.

Even though we have made progress in the way we interact with taxpayers, we are acutely aware of the fact that we can and must do more. Much of the progress to date can be credited to tax systems modernization, but to continue this process, we must fully implement the modernization program by the year 2001.

Future tax systems modernization improvements planned specifically to help the IRS better interact with taxpayers include adding interactive capabilities with our telephone system, which will provide taxpayers with secure, self-help account information capabilities, much like those available today with other financial institutions in the private sector.

For example, taxpayers will be able to use their telephone keypad 24 hours a day to access their accounts, to determine any outstanding balances, receive refund status, or arrange for a tax payment plan, in addition to being able to file their tax returns using their touch tone telephones, as some taxpayers in 10 States can actually do this year.

In making our tax administration system as effective and as efficient as possible, we understand that it is not enough just to modernize our information systems and business systems without updating our 40 year old structure. We are beginning to consolidate the returns processing operations that are now done in 10 service centers into 5 submission processing centers, and we are consolidating the 44 locations where we had 70 phone and correspondence operations into 23 customer service centers. We will be operating with 3 computing centers instead of 12. We are very close to finalizing recommendations about the number and primary functions of our district offices.

The combination of organizational streamlining, business change, and state-of-the-art technology will move us from a paper-based, labor-intensive system to an electronic filing and payment system.

In addition to our financial services and processing lines of business, the IRS is also charged with enforcing the law, both civil and criminal, and collecting taxes that are not paid voluntarily. Although it is only one of our lines of business, our compliance function is probably the best known part of what the IRS does. We estimate that about 83 percent of the taxes due are paid voluntarily, another 3½ percent, or a total of 86.5 percent, is collected annually through compliance and enforcement efforts.

In fiscal year 1994, total enforcement revenue collected by the Internal Revenue Service was $33.7 billion, of which $23.5 billion was a direct result of IRS collection efforts. Total revenue collected last year through compliance was more than four times as much as our entire budget.

We also know that examinations, collection actions, and criminal investigations are, and I fear always will be, essential to demonstrate to those who do comply with the tax law that those who do not comply will be caught. The IRS is continuing to improve its compliance efforts to maximize the revenue collected. Enhancing our research capabilities, the linchpin of future compliance efforts, will enable us to measure voluntary compliance levels nationally and locally to identify broad market segments in industries that are noncompliant and affect taxpayer behavior through a combination of information, education, and enforcement.

Research is helping our compliance employees select the most productive cases for examination, and it is increasing their effectiveness during those examinations, improvements which will not only produce additional revenue but will also reduce taxpayer burden caused by an inefficient audit process.

We also have other tax systems modernization projects under way to increase compliance and reduce taxpayer burden. In addition to automation and compliance efforts, carefully crafted statutory changes relating to the administration of the tax law can also dramatically affect the amount of revenue collected by the IRS.

For example, the 1993 tax legislation changed the point of taxation for diesel fuel from the distributor to the terminal and authorized the dyeing of tax-exempt diesel fuel which reduced fraud and increased dramatically the amount of excise taxes collected. Through the first three-quarters of calendar year 1994, the tax dollars from taxable diesel fuel sales reported on excise tax returns increased by 34.6 percent over the same period in calendar year 1993, even after adjustment for the recent rate increase. That was an additional $1.09 billion.

Although some of the increase in sales reported may be attributable to improved economic conditions, we believe that almost all of the increase is due to greater compliance achieved by moving the collection point from the distributor to the terminal rack, from the dyeing of diesel fuel used for nontaxable purposes, and from greater enforcement efforts.

We could increase collection of excise taxes even more with your help. Diesel fuel fraud, particularly when it involves organized crime, must be addressed through undercover operations that are initiated by our criminal investigation activity. As I testified before this subcommittee last October, undercover fraud operations, particularly diesel fuel fraud investigations, are expensive and currently they must be paid for with appropriated funds.

The Department of Treasury supports giving the IRS authority to use the proceeds of undercover operations to finance them. We had this so-called "churning" authority at one time but the statute lapsed and we think it needs to be reinstated. We are currently the only Federal law enforcement agency without this authority.

Last year with the support of this subcommittee, Congress funded a 5-year compliance initiative for additional compliance programs that have afforded us the first opportunity since 1991 to undertake a multiyear effort to collect the revenue that is owed. Over a 5-year period we estimate conservatively that tax revenue from this initiative will be $9 to $10 billion. This initiative is focused heavily toward the collection of delinquent accounts, with special emphasis on reaching taxpayers quickly by telephone if we have an indication of a delinquency.

I should add that even with the additional compliance initiative staffing in 1995, in the fiscal year we are in now, we are operating with about 3,800 FTE (full-time equivalent) positions fewer than we had in 1992. So we actually have come down over the years in staffing.

We have set an ambitious goal to increase overall compliance to 90 percent by the end of 2001, a goal that will provide an additional $40 billion in tax revenues by 2001 and every year thereafter. With your continued support of the 1995 compliance initiative and tax systems modernization, we are convinced that we can achieve this goal.

I would like now to turn briefly to this year's filing season.

The filing season begins with taxpayers filling out their returns and sending them to the IRS. Earlier, I described what we are already doing to process some returns more efficiently. I also want to describe some steps we have taken to make filling out forms and complying with the law less burdensome for taxpayers.

We recognize that an easier filing season starts with simpler, more understandable forms and instructions. We have concentrated especially on making improvements in forms for small businesses. Examples of those improvements to date include a new streamlined schedule C–EZ for sole proprietors and a much simpler form 940, which is the Federal unemployment tax return, that can be used by two-thirds of all the form 940 filers.

Last year I created an Office of Small Business Affairs, run by Barbara Jenkins, who I believe is here with me today. Her office is working with small businesses to address paperwork and regulatory problems and looking for opportunities to apply technology and increase communications with small business communities.

We are also working with the Social Security Administration and the States to simplify the tax and wage reporting system to eliminate the need for multiple reporting. Last year, the Social Security Administration extracted wage information from the W–2s submitted from 12 States and redistributed this information not only to us, but also to some of the States, eliminating the need for employers to send paper W–2s to those States. This filing season, 28 States have enrolled in the program.

Where we can, we are using technology to get information to taxpayers as quickly and as easily as possible. For example, we now can provide the public with a CD–ROM version of tax forms, publications, and instructions. This means that copies of forms, publications, and instructions, even seemingly hard to find ones, can be printed on demand without having to leave your home or your office. This year forms and instructions, as well as up-to-date information, are available on the information superhighway through FEDWORLD, which is an electronic bulletin board service. That gives the public access to files of tax forms, instructions, and publications which they can print out on their own computers.

This year we expect to respond to 70 million taxpayers through our phone centers. Our telephone assisters will respond to 36 million taxpayer inquiries over our toll-free system, but regrettably this is still only 52 percent of the customers who will request the services of an assister. We want to be able to serve those other 48 percent, too.

Because we understand and feel very strongly that taxpayers must be informed if they are going to file accurate and complete returns, I often say that the front end of compliance really is our taxpayer service function. We are planning to answer 1.3 million more calls this year than we were given the money to do. Unfortunately, as you will hear later from the General Accounting Office, this is still far short of the demand.

We have also expanded our hours of service this filing season. Our telephone lines are now open at least 10 hours a day each work day, and all IRS telephone sites will provide telephone help during three Saturdays in April.

TSM funds are allowing us to replace our equipment with a state-of-the-art telephone system that provides the capability to transfer calls among our toll-free sites so that we can reduce delays and answer more calls. Where that system has been installed, we are already improving productivity by 10 percent, allowing us to answer more taxpayer calls. We also have after hours routing to our automated Tele-Tax system that can address 140 tax topics, as well as provide refund status information.

We are going to be responding to more than 22 million pieces of correspondence this year, and we expect to help more than 7 million taxpayers at our walk-in assistance sites. To further our goal to reduce the burdens on taxpayers, we have expanded the number of our assistant sites this year, offering no-cost electronic filing from the 42 we had last year to 232 this year. Electronic filing at no cost is also available at over 1,000 volunteer income tax assistance sites.

Clearly, our biggest challenge this filing season has been to put in place better methods to protect the tax revenue from those who want to commit fraud. Although the IRS has addressed tax refund fraud through its questionable refund program for many years, technology has significantly improved the capabilities of both government agencies and private financial institutions to deliver money faster. Those shorter payment cycles, coupled with the capacity for electronic payments, require both public and private institutions to be more vigilant than ever in guarding against fraud.

Since 1990, the IRS has steadily increased its efforts to control refund fraud. Significantly more fraud has been identified and stopped by the IRS and more new schemes have been identified. In May 1993, shortly after I was confirmed, I appointed an IRS executive, Ted Brown, right behind me, to coordinate our refund fraud prevention and detection efforts, and we established a coordinating group to assure that our entire organization worked in concert to address problems contributing to refund fraud.

Last spring, in consultation with this subcommittee, the Secretary of the Treasury established a special task force to further study the problem of refund fraud and propose additional preventive actions. In reporting to the Congress last October, the task force estimated that erroneous and fraudulent returns could be costing the Treasury between $1 and $5 billion a year. Since the hearing on the subject of refund fraud before this subcommittee last February, we have taken many steps as part of an agencywide strategy to protect the revenue.

For example, we established new qualification criteria for electronic return originators. We have used both IRS and outside expertise to analyze patterns indicative of erroneous or fraudulent refunds, and we have reprogrammed a series of filters and screens into our processing system. Also, we have made additional staff available to our processing criminal investigation and examination activities to reinforce our refund protection strategy.

One thing all experts on fraud will tell you is that fraud is everchanging. We will continue to use the knowledge we gain about fraud to identify indicators of questionable refunds.

With the Los Alamos National Laboratory, the premier authority in computerized pattern protection, we are building even more so-

phisticated screening techniques than we have today. Obviously, we cannot discuss the specific screens without compromising the effectiveness of these new tools.

This filing season we are carefully reviewing all returns, paper and electronic, to ensure that only those taxpayers who are entitled to refunds receive them. We have spent a lot of time, both before the filing season began and since it got under way, urging taxpayers to use accurate Social Security numbers for themselves and for their dependents, because we are verifying those numbers on all returns.

If you think about an ATM machine at the bank, you cannot get your money out if you do not use the correct PIN number and refunds should be subjected to the same kinds of scrutiny.

We are, as we have repeatedly said we would be doing, slowing down the process to allow us additional time to verify claims before we issue refunds. We estimate that as many as 8 percent of all refunds may be delayed this year. Although some refunds are being delayed in whole or in part, the vast majority of the refunds claimed to date have been paid, and I want to emphasize that they have been paid within the customer service standards that we spelled out in our tax packages: 21 days for electronically filed returns and 40 days for paper returns.

We regret that for some taxpayers, perfectly legitimate refunds will be delayed this year because the initial screening criteria will flag their returns. But I want to emphasize that taxpayers who are entitled to refunds will receive them and those refunds will be sent out as soon as possible. When we have delayed a refund in whole or in part, we are letting taxpayers know why. Our notice explains that the full refund or remaining refund amount will be sent within 8 weeks unless we determine additional contact with the taxpayer will be necessary to verify the claim.

I also want to point out that for true hardships we have our problem resolution program, which is available to provide assistance to taxpayers.

At our hearing before this subcommittee last February, we outlined our four-part refund fraud strategy. First, we felt we needed to develop a better understanding of patterns of fraud and our work with the Los Alamos National Laboratory is an example of this. They are using the same kinds of pattern detection techniques that they did in developing some of the Star Wars technology.

Second, we wanted to prevent recurrences of error or fraud. Checking the accuracy of the Social Security numbers and tightening our policies and procedures for screening electronic return originators are examples of fraud prevention.

Third, we wanted to detect fraud before refunds are paid.

Fourth, we wanted to take vigorous action when we uncover fraud. Working with the Department of Justice and the U.S. Attorneys, we are actively pursuing criminal violations. As I state, we have spent a lot of time this filing season urging taxpayers to be very careful to file accurate returns using correct Social Security numbers for themselves and for their dependents.

In addition to including this cautionary information in our tax packages and all of our filing season publicity, we also worked extensively with the tax preparer community, with financial institu-

tions, before the 1994 season even ended, to let them know we would be taking additional steps this filing season to protect tax revenues against fraud. We also would be soliciting their assistance about how to better accomplish this goal in a way that would be less burdensome to taxpayers.

One subject that I would like to touch briefly on is one we have worked very hard to promote, and that is claiming the earned income tax credit on an advanced basis. Workers who qualify for the advanced earned income tax credit can get up to $105 a month in their paychecks. They can get it whether they are paid weekly, biweekly, monthly or whatever, and they can do it by filling out a simple form W–5, the Earned Income Tax Credit Advance Payment Certificate, and providing it to their employers.

By claiming the earned income tax credit in advance, eligible taxpayers can have the use of the additional money throughout the year. They can also avoid potential delays when they claim the credit after the yearend. In other words, they do not have to wait until they file their returns to get that credit.

Turning to modernization, a fully implemented tax systems modernization program is an integral and necessary part of the IRS' future. For that reason, I understand and all of us at the IRS understand that it is essential that tax systems modernization be effectively managed.

In addition to the progress that we have made toward modernizing the tax system, the IRS has also made significant improvements in our overall management of TSM. Because of the very large financial commitment we are asking for TSM, we understand the need to assure Congress and the American taxpayers that the IRS can indeed implement this program.

In recent testimony before our House Appropriation Subcommittee, the General Accounting Office expressed three basic concerns it had about the successful completion of TSM. The first concern focused on technical and management expertise and skills.

Madam Chairman, we have worked very, very hard to assure that we not only have the IRS personnel necessary to do that job, but that we are also including outside experts in the project.

Probably the most important step I have taken as Commissioner in connection with TSM has been the appointment of Larry Westfall as the modernization executive. On June 30, 1994, I issued a memorandum throughout the Internal Revenue Service detailing his role in managing TSM. He reports directly to me, and my memorandum made it very clear that everyone in the IRS reports directly to him in all matters concerning tax systems modernization. In other words, he is our TSM program manager and has the responsibility for overseeing every aspect of modernization, including the use of outside contractors.

About 75 percent of the proposed TSM budget would pay for contractor-provided products and services. Two major support contractors, the Illinois Institute of Technology and the TRW Corporation, have worked with us for some time to develop and manage our TSM effort. We are also relying heavily on oversight and guidance from the National Research Council and from the General Accounting Office.

GAO's second concern was that new technology would be introduced without making improvements in underlying business processes. We recognize that upgrading information systems alone is not the answer to meeting current and future challenges. Consequently, we have rethought the fundamental way we carry out our mission.

As I briefly touched on a few minutes ago, we are not only redesigning our business systems, but are also reorganizing to take full advantage of modern technology. Taxpayers are already benefiting from the combination of new business approaches and applied technology, for example, with more filing and payment choices and, I think, improved customer service is also out there.

Addressing the GAO's third concern that the IRS set system development priorities and establish performance measures, under Mr. Westfall's leadership, we are establishing management control processes for modernization that demonstrate our commitment to change and our understanding of what it takes to make change happen. We now have schedules for implementing TSM, monitoring the program, and measuring its success. We have plans and schedules against which our performance can be monitored and the success of TSM determined.

Madam Chairman, I stated at the outset that fiscal year 1996 is a pivotal year for us as we continue with our plans to acquire and implement major new systems. What happens to our fiscal year 1996 budget will impact the tax administration system of the future, shaping our ability to effectively administer the tax law and collect all the revenue that is due. TSM will influence most every aspect of this business: Our processing capabilities and the filing season, the effectiveness of our customer service efforts, and our compliance capabilities, including fraud detection and prevention.

I would also like to reemphasize a point that I have made to you and Chairman Archer and many of your colleagues on this subcommittee as I have met with you. I realize that the 104th Congress is considering making changes to the Internal Revenue Code and one of my concerns is that before any legislation becomes final, we be given an opportunity to advise you about issues relating to any burden possible changes may have on taxpayers as well as on the tax administration system. Particularly when legislative changes occur late in the year, the effect on the next filing season can be very significant. Some of that burden that is placed upon taxpayers might be avoided if we could consult with you during the formative stages of the legislation.

I know, Madam Chairman, that you and members of the subcommittee have many questions, but if it fits with your schedule, I would like to ask Mr. Westfall to give you just a brief overview of where we are with TSM and then we would also be delighted to answer your questions.

Chairman JOHNSON. Commissioner, if I may, thank you very much for your thorough overview of the challenges that face the IRS and the great variety of initiatives that you and your staff have developed to address them.

[The prepared statement and attachment follow:]

STATEMENT OF

MARGARET MILNER RICHARDSON
COMMISSIONER OF INTERNAL REVENUE

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT
HOUSE COMMITTEE ON WAYS AND MEANS

FEBRUARY 27, 1995

Madame Chairman and Distinguished Members of the Subcommittee:

With me today are Mike Dolan, Deputy Commissioner; Larry Westfall, Modernization Executive; Phil Brand, Chief Compliance Officer; Bob Wenzel, Chief Strategic Planning and Communication; and Judy Van Alfen, Chief Taxpayer Service. We appreciate the opportunity to be here today to discuss the Internal Revenue Service's FY 1996 Budget request and the 1995 Filing Season.

The United States currently has the best tax administration system in the world. But government at every level is facing new and different challenges. We at the IRS recognize that we can no longer do business as usual. American taxpayers have a right to fair and efficient tax administration from a customer service-oriented organization. To provide this, the IRS must be able to take advantage of technology and business system innovation to effectively collect the revenue owed at the least possible cost and with as little burden as possible for taxpayers. The challenges facing the IRS today -- a growing population, rapid changes in technology, a global economy, and increasing sophistication in business practices -- require innovative and creative approaches to achieve efficient and effective tax administration.

The IRS is at a crossroads, and FY 1996 is a pivotal year for us. Our FY 1996 appropriation will not only shape the agency's future, but, in my opinion, it will affect the quality and effectiveness of tax administration in this country for many years to come.

OUR BUSINESS AND THE NEED TO MODERNIZE

Madame Chairman, this morning, I would like to give you and your colleagues a sense of the range of the IRS's business and what we are doing to operate more effectively and efficiently today and into the next century. The progress toward a more effective tax administration system today, including steps we took to get ready for the 1995 filing season, will pale in comparison to the potential the Tax Systems Modernization program (TSM) will offer us when it is completed in a timely fashion.

Several years ago, with the strong bipartisan support of Congress, the IRS embarked on a plan to update its technology and change its business practices to meet the challenges of tax administration for the rest of the decade and into the next century. That plan, Tax Systems Modernization, is an integrated program to upgrade the IRS's technology and systems in ways that most effectively and efficiently allow us to accomplish our mission which is to collect the proper amount of taxes at the least cost while reducing the burden on taxpayers.

TSM will revolutionize three central processes: 1) capturing data from tax returns and other documents as completely and economically as possible; 2) storing and analyzing data to

improve IRS's ability to maintain accurate taxpayer accounts and correct errors; and 3) providing access and information to authorized employees to improve customer service and compliance.

TSM is an integrated approach that combines updated business practices with updated technology to improve the current tax administration system. Some TSM projects are already a reality. Without this integrated approach to modernization, the IRS will be forced to merely replace in a piecemeal fashion the antiquated system we have today without overall improvement. Despite the progress made so far, we recognize that we have more work to do. As I am certain each of you recognizes, taking full advantage of technology and business system innovation is not an easy task; it takes much careful planning and investing over time.

Before turning to specific details about TSM, I would like to share with you how we accomplish our mission today, and our plans for accomplishing our mission in the year 2001. The IRS is like a large multi-national corporation -- larger than all but a few Fortune 50 companies -- and, like other large multi-nationals, the IRS engages in many different lines of work to accomplish its mission.

We are in the financial services business -- like a bank or credit card company -- and we maintain approximately 200 million taxpayer accounts. As part of this line of business, the IRS responds to taxpayers' account questions, adjusts accounts, sends out bills and processes payments.

PROCESSING RETURNS AND PAYMENTS

In addition to our financial services business, we process tax returns and payments. During 1995, we will process approximately 1.1 billion information documents and approximately 208 million returns, and our "gross receipts" will be over $1.2 trillion. To accomplish this monumental task, the IRS currently uses a factory assembly line-like process. Today processing takes place at ten Service Centers and two Computing Centers by round-the-clock, seven-day-a-week shifts during the height of the filing season. In the days just before and right after April 15th, mountains of mail arrive at our Service Centers by convoys of tractor trailers.

To reduce the burden on taxpayers and enhance voluntary compliance, the IRS must accurately and promptly accomplish this massive processing job. Between 1986 and 1994, the number of tax returns filed increased by almost 15 million, while the staff processing these returns decreased. As a result, the IRS recognized a real productivity improvement of 12.6 percent during that period. The result of this eight-year focus on productivity is that our ten Service Centers are currently operating at virtually their maximum levels of efficiency and quality. With the limitations of our current system, there is little or no further room for productivity increases at the Service Centers.

By the year 2002, the IRS will be receiving 27 million additional tax returns, more than the entire workload of one of our 10 Service Centers today. We are concerned that this increased volume could put at risk our ability to accurately and promptly process returns and payments, particularly since our current system cannot be modified quickly to adjust to tax law changes.

TSM has already begun to help us meet the increased demands on our overburdened infrastructure by providing alternative methods of filing and receiving tax returns and payments. A paper return must travel by mail to the Service Center, be processed through our mail room, transported to a data entry clerk and key punched into the system. This process is not only outdated and labor intensive, but also prone to errors by both taxpayers and the IRS. In contrast, nearly 16 million

electronically filed documents, including 14 million individual tax returns, bypassed these costly and inefficient steps last year. As a result, these electronically filed documents were processed with an accuracy rate of 99.5 percent -- significantly higher than the accuracy rate for paper returns. Errors, by both IRS and taxpayers, represent re-work at a significant cost and burden to the Service and possible cost and burden to taxpayers if we have to contact them to correct errors.

By changing the way we do our business through increased productivity and various alternative electronic filing methods, the IRS is already processing some tax returns and payments more efficiently. But without full implementation of TSM, we will be severely limited in our ability to achieve additional breakthroughs due to the age and capacity of our current systems. The current systems used for receiving and processing returns and payments are nearing or beyond their life expectancy. In contrast, the IRS's modernized system will use fewer resources and accurately capture up to 100 percent of return information that will be available immediately.

Although we are making significant progress modernizing the way we conduct our business, we need your continued support to completely transform our current 1960's assembly-line processing operation into an automated, efficient operation worthy of the 21st century. A fully implemented TSM program will enable us to fundamentally change the way we manage taxpayer accounts, and funding our FY 1996 Budget request will help to ensure that the TSM program is completed in a timely fashion.

TAXPAYER ASSISTANCE

Another way we are changing the way we do business is by finding new and better ways to interact with taxpayers. Recognizing that correspondence is labor- intensive, costly, and burdensome, the IRS has focused on making significant, meaningful improvements to its telephone operations. Taxpayers should be able to get through to IRS on the first call and have their issues resolved. We have already enhanced our systems through TSM, so today IRS representatives anywhere in the country can research and update taxpayers' accounts regardless of where taxpayers live. Future TSM enhancements will include expanded safeguards designed to protect access to taxpayers' accounts and a fuller access to available data.

To improve the way we interact with taxpayers, we have studied and are implementing the best practices of private industry. Our actions will result in better service and increased revenue collection. For example, we can now transfer telephone traffic among 27 sites nationwide to balance workload and maximize service availability to taxpayers.

Although we have made progress in the way we interact with taxpayers, we know that we can and must do more. Much of the progress to date can be credited to Tax Systems Modernization, and, to continue this progress, we must fully implement the modernization program by the year 2001.

Future TSM improvements planned specifically to help the IRS better interact with taxpayers include adding interactive capabilities to our telephone system which will provide taxpayers with secure, self-help account information capabilities, much like those available today with other financial institutions. For example, taxpayers will be able to use their telephone keypad 24 hours a day to access their accounts to determine any outstanding balances, receive refund status, or arrange for a tax payment plan.

ORGANIZATIONAL CHANGE

In making our tax administration system as effective and efficient as possible, we understand that it is not enough to modernize our information systems and business systems without updating the organization's 40-year old structure. A structural change is essential to capitalize on the modern technology and the way we want to do business. In 1993 and 1994, we restructured our Headquarters and Regional Office organizations, and redesigned our methods of supporting compliance and customer service operations. This reorganization has reduced layers of supervision, increased management spans of control, reduced overhead, consolidated support operations (personnel, automation support, training, facilities support), and focused line executives on improving compliance and service to taxpayers.

These efforts are part of our Business Vision -- consolidating functions that were previously dispersed and making the optimum use of technology. We are beginning to consolidate the returns processing operations now done in ten Service Centers into five Submission Processing Centers, and to consolidate the 44 geographic locations where we had 70 phone and correspondence operations into 23 Customer Service Centers. We will be operating with three computing centers responsible for centralized mainframe computing instead of twelve, and we are very close to finalizing recommendations about the number and primary functions of our district offices. The combination of organizational streamlining, business change and state-of-the-art technology will move us from a paper-based, labor intensive system to an electronic filing and payment system.

COMPLIANCE

In addition to our financial services and processing lines of business, the IRS is also charged with enforcing the law -- both civil and criminal -- and collecting taxes that are not voluntarily paid. Although it is only one part of our business, our compliance function is probably the best known part of what the IRS does.

Our research estimates that about 83 percent of taxes due are paid voluntarily. Another 3.5 percent (for a total of 86.5 percent) is collected annually through compliance and enforcement efforts. In FY 1994, total enforcement revenue collected by the IRS was $33.7 billion, of which $23.5 billion was a direct result of the IRS collection organization. Total revenue collected last year was more than four times as much as the entire IRS budget. And while compliance is not directly responsible for the generation of revenue which is voluntarily paid, examinations, collection actions and criminal investigations are, and always will be, essential to demonstrate to those who do comply with the tax law that those who do not comply will be caught.

As part of our efforts in FY 1994 we:

- Increased the number of examinations of foreign controlled corporations and proposed over $8 billion in adjustments, thus making sure that income is taxed in the proper jurisdictions;

- Initiated over 5,340 criminal investigations and recommended prosecution in over 3,740. These investigations covered motor fuel excise taxes, failure to file income tax returns, money laundering, bankruptcy, and other financial crimes;

- Examined 1.4 million income, employment and excise tax returns, proposed additional tax and penalties of $24.4 billion, and disallowed $3.3 billion in claims against the Treasury;

- Examined over 77,700 exempt organizations and 29,300 employee benefit plans; and

- Made determinations on over 62,000 exempt organizations and 53,400 employee benefits plans.

The IRS is continuing to improve its compliance efforts to maximize the revenue collected. Enhancing the IRS's research capabilities -- the linchpin of future compliance efforts -- will enable the IRS to measure voluntary compliance levels nationally and locally; identify broad market segments and industries that are noncompliant; and affect taxpayer behavior through a combination of information, education and enforcement.

As part of TSM, we have acquired the hardware and software needed for our National Office Research and Analysis site, as well as the 31 local District Office Research and Analysis sites. These sites have been staffed and training is underway. This research is helping our compliance employees select the most productive cases for examination and is increasing their effectiveness during those examinations. These improvements will not only produce additional revenue but will also reduce taxpayer burden caused by an inefficient audit process.

We also have other TSM projects underway to increase compliance and reduce taxpayer burden. The Integrated Collection System (ICS) and Totally Integrated Examination System (TIES) automate the examination and collection activities. These systems increase the productivity of field revenue agents, office tax auditors, service center tax examiners and field revenue officers. The TIES and Automated Underreporter (AUR) systems assist compliance personnel by automating previously manual tasks such as report writing, tax and penalty computations and a host of other required actions. These automated systems reduce the time period to complete an examination by as much as several months. ICS, which assists collection personnel with the field collection process, increased revenue officer productivity in the test site by 26 percent and reduced by 20 days the time it took a revenue officer to complete a case. The TSM systems are producing immediate benefits, while at the same time, building the foundations for the fully integrated system of the future.

Automation of Criminal Investigation (CI) is also underway. During FY 1995, we are piloting the initial phase of the new Automated Criminal Investigation (ACI) system that, when fully implemented, will permit CI employees to use information from sources throughout the law enforcement community. In addition, on a broader scale, Tax Systems Modernization will provide enhanced capabilities for detecting and stopping those who try to circumvent the tax system fraudulently.

We have set an ambitious goal to increase overall compliance to 90 percent by the end of 2001 -- a goal that will provide an additional $40 billion in tax revenues by 2001 and every year thereafter. With your continued support of the FY 1995 Compliance Initiative and TSM, we will be able to achieve this goal.

I would like to note that in addition to automation and compliance efforts, carefully crafted statutory changes relating to the administration of the tax law can dramatically affect the amount of revenue collected by the IRS. For example, in the 1993 Omnibus Budget Reconciliation Act, Congress changed the point of taxation for diesel fuel from the distributor to the terminal and authorized dyeing of tax- exempt diesel fuel. This change has reduced fraud and abuse and increased dramatically the amount of excise taxes collected.

Through the first three quarters of calendar year 1994, the tax dollars from taxable diesel fuel sales reported on excise tax returns increased by 34.6 percent over the same period in

calendar 1993, adjusted for the recent rate increase -- an additional $1.09 billion. Although some of the increase in sales reported may be attributable to improved economic conditions, we believe almost all the increase is due to greater compliance achieved by moving the collection point from the distributor to the terminal rack, dyeing of diesel fuel used for non-taxable purposes, and greater enforcement efforts.

The IRS could increase collection of excise taxes even more with the help of this Subcommittee. Diesel fuel fraud -- particularly when it involves organized crime -- must be addressed through undercover operations initiated by our Criminal Investigation activity. As I testified in a hearing before this Subcommittee last October, undercover fraud operations, particularly diesel fuel fraud investigations, are expensive and currently must be paid for with appropriated funds. The Department of the Treasury supports giving the IRS authority to use the proceeds of undercover operations to finance them. IRS had this so-called "churning" authority at one time but the statute lapsed and needs to be reinstated. We are currently the only federal law enforcement agency without this authority.

THE FY 1995 COMPLIANCE INITIATIVE

The IRS has an ambitious goal to raise the overall compliance rate to 90 percent by the year 2001. As I stated, accomplishing this goal will increase the revenue collected without any change in the tax rate. Last year, with the support of this Subcommittee, Congress funded a five-year compliance initiative that provided for an appropriation of $405 million and 6,238 FTEs for additional compliance programs. That initiative affords IRS the first opportunity since FY 1991 to undertake a multi-year effort to collect the revenue owed. Over the FY 1995 - FY 1999 period tax revenue from this initiative is estimated at $9-10 billion. The return on this investment builds each year as new employees become fully productive and additional cases are closed.

As part of the initiative, the IRS has already hired more than 3,300 permanent compliance employees. With further hiring underway, the IRS is poised to fully utilize all of the much needed resources provided in this initiative. This initiative is focused heavily toward the collection of delinquent accounts, with special emphasis on reaching taxpayers quickly by telephone if we have an indication of a delinquency.

Even with the additional staffing, in FY 1995 IRS is operating with about 3800 FTE fewer than we had in FY 1992. Because of improvements in management and the impact of our early TSM projects, we have placed more FTE in compliance and accounts maintenance work and proportionately fewer in processing returns and correcting errors. As part of TSM, we have a number of projects underway to increase compliance and reduce taxpayers' burden. These systems are producing immediate benefits, while at the same time, building the foundations for the fully integrated system of the future.

TAX SYSTEMS MODERNIZATION

A fully implemented Tax Systems Modernization program is an integral and necessary part of the IRS's future. For that reason, I understand, and all of us at the IRS understand, that it is essential that TSM be effectively managed. In addition to the progress that we have made toward modernizing the tax system, the IRS has also made significant improvements in our overall management of Tax Systems Modernization. Because of the very significant financial commitment we are asking for TSM, we understand the need to assure Congress and American taxpayers that the IRS can implement this program.

In our recent testimony before the House Appropriations Subcommittee on Treasury, Postal Service and General Government, the GAO expressed three basic concerns it had about the successful completion of TSM. The first concern focused on technical and management expertise and skills. Madame Chairman, we have worked hard to assure that we not only have the IRS personnel necessary to do the job, but that we are also including outside experts in the project.

About 75 percent of the proposed TSM budget would pay for contractor provided products and services. Two major support contractors, the Illinois Institute of Technology and the TRW Corporation, have worked with us for some time to develop and manage the TSM effort. We also are relying heavily on oversight and guidance from the National Research Council, as well as the GAO.

The second concern was that new technology would be introduced without making improvements in underlying business processes. We recognize that upgrading information systems alone is not the answer to meeting current and future challenges. Consequently, we have rethought the fundamental way we carry out our mission. We are not only redesigning business systems but are also reconfiguring our organization to take full advantage of modern technology. Taxpayers are already benefitting from the combination of new business approaches and applied technology, for example, with more filing and payment choices and improved customer service.

Maybe the most important step I have taken as Commissioner in connection with TSM has been the appointment of Larry Westfall as the Modernization Executive. On June 30, 1994, I issued a memorandum throughout the IRS detailing his role in managing TSM. He reports directly to me and my memorandum made it very clear that everyone in the IRS reports directly to him in all matters concerning TSM. In other words, he is the TSM program manager and has the responsibility for overseeing every aspect of modernization, including the use of outside contractors.

Under his leadership, we have also established management control processes for modernization that demonstrate our commitment to change and our understanding of what it takes to make change happen. We believe this addresses GAO's third concern -- that the IRS set system development priorities and establish performance measures.

As part of this new approach, we have conducted a number of critical project reviews to ensure the early identification and resolution of issues. These reviews will enable us to better identify and control risks involving modernization and ensure that we remain on track.

We now have schedules for implementing TSM, monitoring the program and measuring its success. Our Business Master Plan, Integrated Transition Plan and Schedule, and the Concepts of Operations were prepared this past year and these documents provide the program and project level priorities for TSM. They clearly identify the milestones and accountability for development of the operational capabilities that create the modernized IRS. They also form the baseline set of plans and schedules against which our performance can be monitored and the success of TSM may be determined.

The Modernization Executive is working with the Infrastructure Project that was established in the Chief Information Officer organization to complete delivery of the remaining architectural and integrated design components of TSM by summer 1995. Next month, as we committed to the Subcommittee on Treasury, Postal Service, and General Government, we will provide Congress a timetable for the systems architecture and integration requirements and comprehensive data standards.

The Chief Financial Officer has established a new Office of Economic Analysis to certify annual budget estimates for TSM, oversee an independent cost analysis for TSM, and develop a new economic analysis process for determining TSM costs and benefits.

THE FILING SEASON - MAKING COMPLIANCE EASIER

I would like to turn to this year's filing season. The filing season begins with taxpayers filling out their returns and sending them to the IRS. I have already described to you the things the IRS is doing to process these returns more efficiently. I would also like to describe some steps we have taken to make filling out forms and complying with the law less burdensome for taxpayers.

An easier filing season starts with simpler, more understandable forms and instructions. We have concentrated especially on making improvements in forms for small businesses. Examples of improvements to date include a new streamlined Schedule C-EZ for sole proprietors and a much simpler Form 940 (Federal Unemployment Tax Return) that can be used by two-thirds of all Form 940 filers. Last year, I created an Office of Small Business Affairs, run by Barbara Jenkins who is with me here today. This Office is working with small businesses to address paperwork and regulatory problems and looking for opportunities to apply technology and increase communication.

We are also working with the Social Security Administration and the states to simplify the tax and wage reporting system. This concept calls for all federal and state wage and employment taxes to be reported to a single point which will distribute information, eliminating the need for multiple reporting. Last year, the Social Security Administration extracted wage information from the W-2s submitted from 12 states and redistributed this information to IRS and the states eliminating the need for employers to send paper W-2s to those states. This filing season, 28 states have enrolled in this program.

Reducing a taxpayer's burden in meeting his or her tax obligations is one of our three business objectives -- along with improving compliance and enhancing productivity. We want to make it easier for taxpayers to get the information they need to file accurate returns; we want to make the returns themselves easy to understand and file; and after taxpayers file, we want to make it simple to resolve account problems.

Wherever we can, we are using technology to get information to taxpayers as quickly and easily as possible. For example, we now can provide the public with a CD-ROM version of tax forms, publications and instructions. This means that copies of forms, publications and instructions -- even seemingly hard to find ones -- can be printed on demand without leaving your office. We are also making forms and instructions as well as up-to-date information available on the Information Superhighway. Tax forms are now available electronically on FEDWORLD, an electronic bulletin board service operated by the National Technical Information Service, an agency of the Department of Commerce. This service gives the public direct dial-up access to files of official IRS tax forms, instructions and publications which they can download onto a computer for printout.

Taxpayers must be informed if they are going to file accurate and complete returns. This year, we expect to respond to 70 million taxpayers through our phone centers. Our telephone assistors will respond to 36 million taxpayer inquiries over the toll-free system, but this is still only 52 percent of the customers who will request the services of an assistor -- we would like to be able to serve the other 48 percent, too. The FY 1996 Budget will allow us to answer an additional 1.3 million callers -- still far short of demand.

This filing season we have expanded our hours of service. Our telephone lines are now open at least 10 hours a day each work day within the continental U.S., and all IRS telephone sites will provide telephone help during three Saturdays in April. TSM funds have allowed us to replace our equipment with a new state-of-the-art telephone system that has provided us the capability to transfer calls among our toll-free sites so that calls can be transferred from those sites that are at or over capacity. This new system is already improving productivity by 10 percent where implemented, allowing us to answer more taxpayer calls. In addition, we have after-hours routing to our automated Tele-Tax system that can address 140 tax topics as well as automated refund status information.

We also provide other types of assistance. We will respond to more than 22 million pieces of correspondence and this year we expect to help more than seven million taxpayers at IRS walk-in assistance sites. To further our goals to reduce the burdens on taxpayers, we have expanded the number of our assistance sites offering no cost electronic filing from 42 last year to 232 this year. Electronic filing at no cost is also available at over 1,000 Volunteer Income Tax Assistance (VITA) sites.

THE FILING SEASON - REVENUE PROTECTION

Our biggest challenge this filing season has been to put in place better methods to protect the tax revenue from those who want to commit fraud on the system. IRS has addressed tax refund fraud through its Questionable Refund Program for many years. Teams of trained personnel in each of the Service Centers have used both manual techniques and computerized criteria to determine which returns need review. However, technology has significantly improved the capabilities of both government agencies and financial institutions to deliver money faster. But shorter payment cycles and electronic payments require both public and private institutions to be more vigilant than ever in guarding against fraud.

Since 1990, the IRS has steadily increased its efforts to control refund fraud -- significantly more fraud has been identified and stopped by IRS and more new schemes have been identified. In May 1993, I appointed an IRS executive to coordinate our refund fraud prevention and detection efforts and established a coordinating group to assure all components of the IRS worked in concert to address problems contributing to refund fraud. Since the hearing before this Subcommittee last February, we have taken many steps as part of an agency-wide revenue protection strategy. We established new criteria for qualifying Electronic Return Originators. We used both IRS and outside expertise to analyze patterns indicative of erroneous or fraudulent refunds and programmed a series of filters and screens into our processing system. Also, we have made additional staff available to our processing, criminal investigation and examination activities to reinforce our Refund Protection Strategy. Last spring, in consultation with this Subcommittee, the Secretary of the Treasury established a special task force to further study the problem of refund fraud and propose additional preventive actions. In reporting to the Congress last October, the task force estimated that erroneous and fraudulent returns could be costing the Treasury between one and five billion dollars.

This filing season, we are carefully reviewing all returns -- paper and electronic -- to ensure that only those taxpayers who are entitled to refunds receive them. We have spent a lot of time both before and during this filing season urging taxpayers to be very careful to use accurate Social Security Numbers (SSNs) for themselves and for their dependents because we are verifying those numbers on all returns. Refunds are being delayed on returns with missing or incorrect SSNs and on some returns claiming refundable credits to allow us additional time to verify

claims prior to issuing the refunds. We are using the knowledge gained in recent years to identify indicators of questionable refunds. With the Los Alamos National Laboratory -- the premiere authority in computerized pattern detection -- we are building more sophisticated screening techniques. Obviously, we cannot discuss the specific screens without compromising the effectiveness of these new tools.

We regret that for some taxpayers, perfectly legitimate refunds will be delayed this year because the initial screening criteria flag their returns. But I want to emphasize that taxpayers who are entitled to refunds will receive them -- as soon as possible. For true hardships, the Problem Resolution Program is available for assistance. We estimate that up to eight percent of all refunds may be delayed this year.

When we have delayed a refund in whole or part, we are letting taxpayers know why. Our notice explains that the full refund or remaining refund amount will be sent within eight weeks unless we determine additional contact with the taxpayer is necessary to verify the claim.

At our hearing before this Subcommittee last February, we outlined our four- part refund fraud strategy:

- First, we are developing a better understanding of patterns of fraud -- our work with the Los Alamos National Laboratory is an example of this.

- Second, we want to prevent occurrences of error or fraud. Checking the accuracy of SSNs is an example of this. Assuring that we have policies and procedures for screening Electronic Return Originators before permitting them to access the IRS electronic filing system is another example of fraud prevention.

- Third, we want to detect fraud before refunds are paid.

- The fourth part of our strategy is that we will take vigorous enforcement action when we uncover fraud. Working with the Department of Justice and the U.S. Attorneys, we are actively pursuing criminal violations. In the federal system, approximately 98 percent of the indictments involving refund fraud result in conviction, and the average incarceration is 17 months.

As I stated, we have spent a lot of time this filing season urging taxpayers to be very careful to file accurate returns using the correct SSNs for themselves and their dependents. In addition to including this cautionary information in our tax packages and in all of our filing season publicity, we also worked extensively with the tax preparer community and with financial institutions before the 1994 filing season even ended, to let them know we would be taking additional steps this filing season to protect tax revenues against fraud and soliciting their assistance about how to better accomplish this goal in a way that would be the least burdensome to taxpayers.

ADVANCED EARNED INCOME CREDIT

I could not conclude without mentioning a subject that I, the Treasury Department and the Administration have worked hard to promote -- the Advanced Earned Income Tax Credit (AEITC). Workers who qualify for the AEITC can get up to $105 per month in their paychecks -- whether they get paid weekly or bi-weekly -- by filling out a very simple Form W-5, Earned Income Tax Credit Advance Payment Certificate and providing it to their employers. Sixty percent of the total credit available to workers with a qualifying child is distributed as an addition to their paychecks; the other 40 percent is paid in a lump sum when they file their returns. By claiming the earned income credit on an

advanced basis, taxpayers who are eligible for the Earned Income Tax Credit can avoid potential refund delays and use the funds during the year. They don't have to wait until they file their return to get the credit.

CONCLUSION

In conclusion, Madame Chairman, I stated at the outset that FY 1996 is a pivotal year for the IRS as we continue with our plans to acquire and implement major new systems. What happens to our FY 1996 Budget will impact the tax administration system of the future, shaping our ability to effectively administer the tax law and collect all the revenue that is due. I have highlighted for you today the progress the IRS has made in changing the way we do business. TSM will influence most every aspect of that business -- our processing capabilities and the filing season, the effectiveness of our customer service efforts and our compliance capabilities including fraud detection and prevention. It is essential now that we have the funding needed to capitalize on the progress that we have already made. Without adequate funding, TSM will not simply be delayed. Only modest, incremental improvements in business processes could be achieved, and the IRS would in any event have to begin replacement of obsolete equipment that would otherwise fail over the next few years. Investing in TSM makes good business sense and will enable us to effectively meet the challenges of tax administration in the next century.

In closing, I would like to reemphasize a point that I have made with Chairman Archer and many of you in our recent meetings. I realize that the 104th Congress is considering changes to the Internal Revenue Code. One of my concerns is that the Department be given an opportunity to advise you before legislation is finalized of any burden possible changes may have on taxpayers as well as the cost to the Service before legislation is finally adopted. Particularly when the legislative changes occur later in the year, the effect on the next filing season can be significant. Some of the burden that is placed upon taxpayers might be avoided if the Department is able to consult with you during the formulative stages of the legislation.

Madame Chairman, I know that the members of the Subcommittee have many questions to ask. If it fits your schedule, I would now like to ask Mr. Westfall, our Modernization Executive, to give you a brief overview of where we are going with TSM. We then would be delighted to answer any questions you might have for us. For your reference, I have included as an appendix a summary of the 1996 Budget request.

Internal Revenue Service

BUDGET OVERVIEW FY 1996

Prepared by:
Chief Financial Officer
Budget Division

The President's Budget for FY 1996

The 1996 President's Budget enables the IRS to continue its overall mission by funding basic ongoing operations and programs and providing additional resources for specific initiatives. The attached Appendix is a comparison of the FY 1994, FY 1995, and FY 1996 IRS budgets by budget activity.

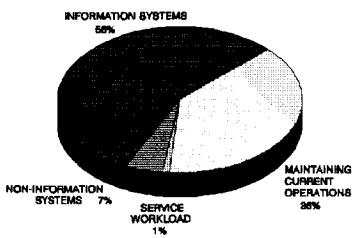
Overview

The FY 1996 resource requirements for the IRS are 114,885 FTEs and $8.228 billion.

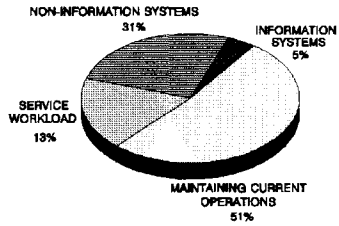
The Service's net increase in resources over FY 1995 is $739 million and 922 FTE. The total proposed increases for the Service are $844 million and 1,930 FTEs in the following:

-- Tax Systems Modernization (TSM)
-- Non TSM Systems: Storage Peripheral Replacement Unisys Computer Equipment (SPRUCE)
-- Revenue Protection/Tax Refund Fraud
-- Tax Account Telephone Resolution
-- Automated Criminal Investigation (ACI)
-- Service Center Workload Growth
-- Maintaining Current Operations

FY 1996 BUDGET INCREASES
($844 Million)



FY 1996 BUDGET INCREASES
(1,930 FTE)

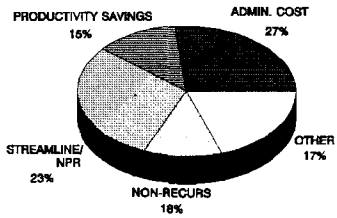


These increases are partially offset by proposed reductions of $105 million and 1,008 FTE.

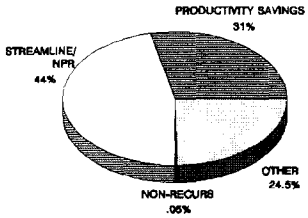
These reductions include:

-- Productivity Savings
-- Administrative Support Costs
-- Streamlining/NPR Staffing
-- One-Time (Non-Recurring) Costs

FY 1996 BUDGET DECREASES
($105 Million)



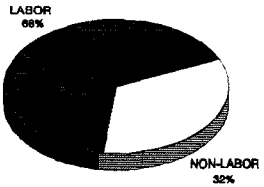
FY 1996 BUDGET DECREASES
(1,008 FTE)



Labor Costs

Labor costs are the single largest component of the IRS budget, representing almost 70 percent of the FY 1996 request. Adjustments to labor costs for FY 1996 total over $235 million.

LABOR VS. NON-LABOR COSTS



Annualization of FY 1995 Pay Raise

Because the FY 1995 pay raise took effect in January 1995, the base budget includes only enough resources to fund those pay raises for three quarters of the year. It will cost the IRS an additional $32 million to pay the FY 1995 pay raises for a full year in FY 1996.

FY 1996 Pay Raise/One More Day's Pay

The Administration estimates that there will be a 2.4 percent pay raise effective in January 1996. For three quarters of the year, this pay raise will cost the IRS $92 million. FY 1996 has 261 workdays, one more than FY 1995. The Service requires an additional $20 million, the average daily labor cost.

Benefits

The FY 1996 budget includes $11 million for projected changes for the government's share of health insurance, retirement, and workers compensation.

Non-Pay Raise Labor Costs

While the budget process regularly addresses the labor cost changes discussed above, the Service also experiences other cost growth resulting from promotions, step increases, and upgrades. These costs can be offset if there is a high turnover in the workforce. However, the low attrition rates of the last few years have given the Service a workforce with more seniority, requiring an additional $79 million for higher salaries and benefits.

Other Adjustments

The FY 1996 budget includes some non-labor cost adjustments which modify our ongoing operations rather than support new or expanded programs. These are a net reduction of $28 million and 67 FTE.

Administrative Cost Reduction

In 1993, the President issued Executive Order 12837, which required all agencies to reduce administrative costs by not less than 14 percent between 1994 and 1997. The mandated reduction for FY 1996 is three percent (as it was in FYs 1994 and 1995) which will reduce the Service by $34 million.

Streamlining/NPR Reductions

As part of IRS' implementation of the recommendations included in the Vice President's National Performance Review (NPR), IRS is reducing 442 FTE and $27 million to reduce the overall size of government. These FTE will be supervisors and oversight personnel.

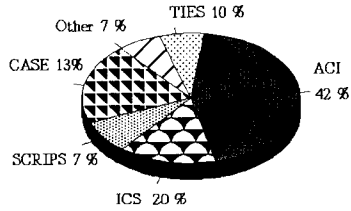
Non-Recurring Costs

When resources are no longer needed by the Service for the purposes for which they were originally provided, they are removed from our budget. For FY 1996, this includes $22 million and 9 FTE, including $11 million for expected telephone savings and $9 million for furnishing/equipment in our new office building.

Productivity Savings

As new automated systems are brought on-line, Service activities realize productivity savings which are removed from our budget. For FY 1996, productivity savings are associated primarily with Automated Criminal Investigation (ACI), Totally Integrated Examination Systems (TIES), Integrated Collection Systems (ICS), Service Center Recognition/Image Processing System (SCRIPS), and Counsel Automated Systems Environment (CASE).

FY 1996 PRODUCTIVITY SAVINGS
(Total Savings = $19.2M and 313 FTE)



Postage

A postal rate increase went into effect in January 1995. This budget includes an additional $5 million to fully fund postage costs in FY 1996.

Inflation

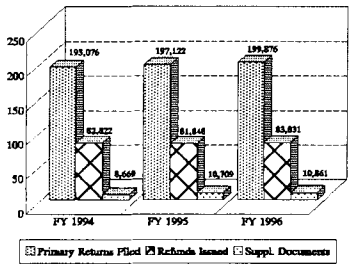
Each year, our budget request includes an increase based on expected cost growth (inflation) over the current year. The IRS budget includes $59 million for inflation for FY 1996.

Service Center Workload Growth

In FY 1996, the IRS will need to process an additional 2.8 million primary tax returns and issue 1.2 million more refunds than in FY 1995. We also expect that supplemental documents (amended returns, extensions to file, etc.) will increase by 0.2 million. This workload increase is directly related to the growth in the taxpayer population. In order to

process this additional workload without jeopardizing timeliness, quality, or customer service, our budget includes an increase of $12 million and 243 FTEs.

RETURNS PROCESSING WORKLOAD
(# in 000s)



Initiatives

In addition to labor and non-labor cost adjustments to ongoing operations, our FY 1996 budget also includes $533 million of real program growth.

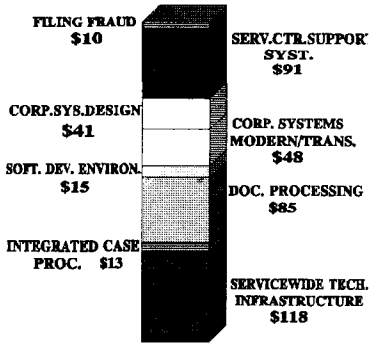
Tax System Modernization (TSM)

The FY 1996 budget includes an increase for TSM of $421 million and 95 FTE, bringing the total TSM request to over $1 billion. The increase will be used to:

-- provide automated tools for our front-line compliance and customer service staff. These tools allow us to close cases up to ten weeks sooner while improving revenue results ($118 million);

-- provide imaging and scanning equipment at our processing centers to process paper tax returns by making a digital image of the document. This will significantly reduce the staff needed to process tax returns while capturing 100 percent of the document data (versus 40 percent today) ($85 million);

FY 1996 TSM PROGRAM INCREASE BY PROJECT
($421 Million and 95 FTE)



-- acquire hardware and software applications to store and analyze data captured through electronic filing and imaging of paper documents. This will enable us to identify and resolve all relevant issues in a single contact with taxpayers ($138 million);

-- build the hardware and telecommunications infrastructure necessary to support TSM and to protect the systems against violations of taxpayers' privacy and fraudulent returns ($80 million).

Storage Peripheral Replacement Unisys Computer Equipment (SPRUCE)

Until TSM is fully operational, our current systems must continue to be maintained. The FY 1996 increase of $51 million is essential to replace the overage and undependable tape and disk environment which was placed into service between 1981 through 1987 and represents tape subsystem technology which is over 20 years old.

Tax Account Telephone Resolution

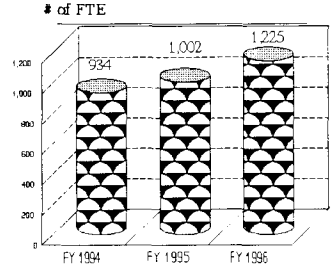
As the IRS increases its customer satisfaction focus, telephones have become a major contact between taxpayers and the IRS. Each year we answer more calls, but the total number of calls from taxpayers (answered and unanswered) grows even faster. Productivity improvements alone will not enable us to keep up with the demand. This initiative provides $17 million and 239 FTE to handle an additional 1.3 million telephone calls.

Revenue Protection/Refund Fraud

The IRS is requesting additional support for a cross-functional effort to combat tax refund fraud. This effort identifies and stops the payment of fraudulent refunds, detects schemes, and investigates fraud. Over the past few years, the dollar value of fraudulent refund claims detected has increased dramatically from $43 million in 1991 to $461 million in 1994 (through 12/31/94).

To help combat this increased fraud, IRS is requesting an additional $28 million and 323 FTE to detect and stop fraudulent refunds; identify and refer for audit those Earned Income Tax Credit (EITC) cases with audit potential; handle the rapidly increasing volume of calls associated with fraud; and investigate and prosecute at least the most flagrant cases.

LEVEL OF RESOURCES DEVOTED TO IDENTIFYING AND INVESTIGATING FRAUDULENT REFUND SCHEMES



Automated Criminal Investigation (ACI)

The Service is requesting an increase of $3.5 million for the purchase of investigative equipment, including laptop computers, desktop workstations, and necessary software.

Crime Bill

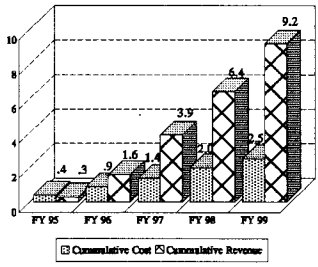
The Violent Crime Control and Law Enforcement Act of 1994 (commonly known as the Crime Bill) provided $7 million to the IRS in FY 1995 for combating public corruption and enhancing illegal tax enforcement activities. The Service requests additional funding in FY 1996 of $12 million for a total of $19 million.

The FY 1996 funds will be used to supplement current efforts for Revenue Protection/Refund Fraud and the Automated Criminal Investigation System.

Compliance Initiative

In FY 1995, IRS worked with Congress on a budget strategy that permitted funding of $405 million and 6,238 FTEs in additional compliance programs. Tax revenues from these initiatives are estimated at between $9 and $10 billion over the FY 1995-1999 period. The budget strategy was to devote $405 million in each of the next five years to these compliance initiatives. The FY 1996 budget again includes $405 million for the initiatives. In addition, one-time costs in FY 1995, which would normally be non-recurred, have instead been reinvested in an additional 546 FTE, bringing the total FY 1996 compliance initiative FTE to 6,784.

FY 1995-1999 COMPLIANCE INITIATIVES ($ in Billions)



The FY 1995 initiative is the first step in a long-term strategy to improve voluntary compliance by investing streamlining and modernization savings into front-line compliance and customer service activities.

The key areas are:

- Income Tax Underreporting: Increase the number of correspondence audits and contacts; improve compliance by Federal Government payers; correct wage reporting by the military; and reduce the number of unmatchable documents.

- Excise Tax Fraud/Pension Plans: Increase resources dedicated to detecting motor fuel excise tax evasion schemes, bankruptcy fraud in pension plans, and insurance fraud, and investigating refund fraud.

- Foreign Controlled Corporations: Expand coordination and litigation, concentrate resources on the development and implementation of Advance Pricing Agreements, and increase enforcement based on identified market segments by targeting foreign business activity in the U.S.

- Underpayment/Non-Filing: Increase the collection of delinquent accounts by improving case selection and prioritization, faster case assignment, and accelerated taxpayer contact, and by obtaining delinquent returns and collecting delinquent taxes.

User Fees

In the FY 1995 budget, the IRS proposed three user fees to raise $147 million to supplement appropriated resources. The Congress changed our approach, allowing us to charge and collect any user fees that we were otherwise authorized to initiate and to spend up to $119 million of the collected fees to supplement appropriations. For FY 1996, the IRS budget proposes no changes to Congress' direction.

Conclusion

FY 1996 is a critical year for tax administration, and the Service's budget request responds to this challenge. Continued modernization of our existing overaged tax systems, timely and effective enforcement of the tax laws, and strong support for customer service are the bases of this budget. As the IRS re-engineers itself for tax administration in the 21st Century, we are committed to fair, effective, efficient and constantly improving revenue collection.

FY 1996 CONGRESSIONAL SUBMISSION
SUMMARY
($ in millions)

	FY 94		FY 95		FY 96		+/- FY 95/96	
	$ AMT.	FTE	$ AMT.	FTE	$ AMT.	FTE	$ AMT.	FTE
TOTAL	$7,245	110,665	$7,489	113,963	$8,228	114,885	$739	922
Processing, Assist. & Mgmt.	1,674	32,331	1,704	33,141	1,805	33,528	101	387
- Returns Processing	770	20,828	777	21,366	830	21,599	53	233
- Taxpayer Service	305	8,206	297	8,273	329	8,510	32	237
- Inspection	104	1,315	109	1,410	112	1,364	3	-46
- Management Services	297	1,784	315	1,907	320	1,850	5	-57
- Resources Management	198	198	206	185	214	205	8	20
Tax Law Enforcement	4,212	69,304	4,397	71,339	4,543	71,871	146	532
- Examination	1,534	27,599	1,580	28,025	1,635	28,267	55	242
- International	42	596	46	616	46	618	0	2
- Tax Fraud	412	4,895	416	5,013	446	5,078	30	65
- Counsel	388	5,450	408	5,585	419	5,652	11	67
- EP/EO	130	2,283	134	2,370	140	2,367	6	-3
- SOI/Compliance Research	59	845	62	874	63	876	1	2
- Collection	853	18,188	885	18,562	909	18,651	24	89
- Document Matching	113	3,264	116	3,354	122	3,385	6	31
- Compliance	-	-	30	561	30	564	0	3
- Resources Management	681	6,184	720	6,379	733	6,413	13	34
Information Systems	1,359	9,030	1,388	9,483	1,880	9,486	492	3
- TSM	573	2,363	622	2,489	1,032	2,572	410	83
- Non-TSM	786	6,667	766	6,994	848	6,914	82	-80

Note: FY 1994 and FY 1995 adjusted to reflect new budget structure

Chairman JOHNSON. I certainly do want to hear from Mr. Westfall, but I think we might as well hear from him in the context of a first question. Because while you have quoted the GAO's concerns about the tax modernization system, I would like to quote from their testimony more specifically because I think it is very important that the subcommittee get a better understanding of what the problems are, what you are trying to do, and what you think you are accomplishing versus some of those who are looking to see what they think you are accomplishing or concluding.

The GAO does say that the IRS has realized only marginal improvements in its operations. They go on to say that the changes are not built to be an integrated part of the comprehensive TSM program and they have not delivered the large increases in capability and customer service that the IRS hopes to be able to deliver in the future. They then go on to say that the IRS has not defined a consistent focus for making TSM investment choices.

In other words, they draw a picture of your not having a clear road map of where you are going and of your expenditure of the first $2 billion of the $8 billion allocated for tax modernization, having spent those first $2 billion in ways that have resulted in only marginal improvements, but almost more seriously they have not been chosen in a way so that they then become building blocks and pieces of the ultimate system.

So, Mr. Westfall, we do invite your comments and appreciate your being here.

Ms. RICHARDSON. I would just like to say, before turning it over to Mr. Westfall, that we do disagree with the General Accounting Office in their assessment of where we are. I will say that we would like to be providing even better customer service, and I think that statement is one we do agree with, but we are at the beginning of the process of modernization, and as I think Mr. Westfall will be able to describe to you, we have made some significant improvements in the way we are able to serve taxpayers even today. I think that, as I say, we do not agree with their characterizations.

So, Larry, you may want to——

Chairman JOHNSON. Mr. Westfall, I have forgotten from Commissioner Richardson's testimony how long you have been on board.

Mr. WESTFALL. I have been assigned here in the Washington office on this tour for 4 years. I have been in the present position as program manager for TSM since last June.

Chairman JOHNSON. Thank you.

Mr. WESTFALL. I think that there is perhaps a fundamental issue associated with whether we are building a long-term unique new system or are we transitioning the Internal Revenue Service through a critical number of filing seasons that have to be successful and headed toward a totally new way of operating in the future, which we will reach at a point in time.

GAO has referred to a perceived marginal progress. We believe that we have made substantial progress in beginning to take actions that transition us toward the system that we have to operate in in the future. I will give you an example or two of that.

Essentially——

Chairman JOHNSON. Mr. Westfall, if you will yield for just a moment. It occurs to me that I think it would be useful to the sub-

committee if after you finish, we all question you on the issue of the tax systems modernization program. Then we can go on as a subcommittee to some of the other issues because there are some equally important issues, but this one is complicated. So after you have finished, we will proceed in that way.

Mr. WESTFALL. Madam Chairman, if you do not mind, I would like to stand and answer this first question from an overhead.

With the Commissioner's indulgence, I may put this smack in front of her for purposes of presentation—perhaps the easel will work better here.

Chairman JOHNSON. Actually, if you put it over there, it is all right or even back further where you have more room.

Mr. WESTFALL. You are saying work from back here?

Mr. LEVIN. We are using the same old systems here.

Ms. RICHARDSON. We are sympathetic to that.

Chairman JOHNSON. If we were state of the art, you would be able to press a button and it would have gone overhead and we would have screens on both sides of the room.

Mr. WESTFALL. That is exactly what this is, a state-of-the-art presentation.

I think people sometimes get confused about TSM. They think it is too long, too complicated, and not happening. We keep building something which people have difficulty understanding is taking place. What I want to do is just take a couple of minutes from a business standpoint to communicate to you what TSM is, first of all, as a backdrop against which to answer the question.

Through a series of projects over a number of years, what we seek to do is take a very large paper-based and old batch-oriented operation into the future. It is very simple. It simply involves a business terminology seeking to capture data, to store and analyze data, and to distribute and use data in this large information system in a state-of-the-art environment, instead of the environment that we are in today.

It goes to four or five fundamental business objectives. You have to understand that we seek to operate as much like a business as we can in the future. We are one of the largest, if not the largest, information organizations in the world and we cannot find our information many times.

You made the point, Madam Chairman, of the paper trailing the world, and that paper-based environment causes us to be ineffective and inefficient in serving our customer, the taxpaying public in this country. The objectives of the system go like this.

The first one, just as a large bank or other financial institution, a credit card company or a large insurance company, we seek to take our business, to the extent that we can in the future, electronic. They are going electronic. It is an electronic commerce that exists in the business environment of information today, and we need to become electronic as well.

So as the first major phase of change for the future, we seek to take returns electronic, to the extent possible; to take remittances electronic, to the extent possible. Electronic in this context goes beyond just electronic transmission in the form of computer to computer. It also addresses the issue of things like tax returns being filed by telephone. That is a major component, to take as much of

the paper activity in the future electronic, as we can, for the obvious business value that you get out of that.

Second, we recognize that in the year 2000 to 2001, we will still have large amounts of paper in the system. The preponderance of the system will still be paper in many respects. We seek to use image technology, character recognition technology in ways that allow us to reduce the labor-based environment that we now use to put information in the system. By using scanning, using character recognition, and using more sophisticated systems, we can get much more of the information from tax returns into the system than we can afford to manually key stroke in today. We are already proving that we have the ability to massively take the errors out of the system through this kind of technology. So the first thing we do is go electronic.

The second thing we do is become much more efficient and effective at processing the residual paper that exists. Through a combination of this, we pick up much more information both in the form of computer-based information and also images of documents and tax returns and get that into a computing environment which does not exist today. Our master files can be enhanced by considerably more information and also made available online by workstation accesses throughout the system. We can be more responsive to the public and the public can get access to the information that it needs in connection with its tax account records.

All this enables that corporate computing center database to drop information into, No. 1, our customer service operation. In our customer service operation for the future, there is a basic fundamental thing that we seek to do that we have never been able to do effectively as we feel we must. It involves doing business with the taxpaying public by telephone.

We simply have to use the telephones in the business of taxation much more extensively than we do or we have in the past. We have to be able to get access to information on a 24-hour-a-day basis, instead of a 9 to 5 basis. We have to be able to reduce the cost of a personal contact with a taxpayer or the necessity of burdensome notices and letters that cross in the mail by acting quickly on a tax account issue and doing it, wherever possible, with a telephone contact with the taxpayer that will much more quickly and much more effectively close the issue out.

Finally, we also need to put information in our field compliance activities so that our revenue officers, our revenue agents, our tax auditors can get faster access to more information with more computer assistance. This will enable us to better segment the taxpaying public, better segment compliance zones, focus our compliance resources on education and assistance in compliance actions designed to impact a particular industry that has a significant compliance issue, and impact that industry industrywide, instead of doing one audit at a time with a lot of manual work that we have to do in the system today.

From a business perspective, that is the environment that we seek to create in the future. I will make about 30 seconds' worth of points from this second overhead to complete the presentation.

In this overhead, which is also in your information packet, we seek to demonstrate progress made to date toward the ultimate

business objective that we are moving toward. The first point I make from this is that during the years 1992–95, with the systems that we have already put online, we have generated productivity savings in excess of 11,000 full-time equivalent positions that have been declared and given up from the IRS budget base. That is also a large amount of money.

To show progress made in one particular area, we seek to make 80 million tax returns and essentially all of the remittance activity in our system electronic. To date we have 16 million returns that are active electronically in the system, nearly 1 million of which this year will be filed by telephone for taxpayers capable of filing the simple 1040–EZ return utilizing telephone access.

This year, we also will have 2.2 million taxpayers in 29 States who will be capable of filing a single tax return electronically that will satisfy both the Federal and the State obligation simultaneously. This is a major burden reduction issue for the taxpaying public. It is something that we do not view as marginal, in terms of the progress being made and putting a choice in front of taxpayers to file electronically, to get access in some cases to telephone filing, and to be able to satisfy both a Federal and State obligation at one time.

The other thing that we will do this year is put about $160 billion electronically in the Federal tax deposit system. Essentially, that is a major step toward the $1.2 trillion total amount of revenue that we handle each year.

In closing, we believe that the progress made has been major, not marginal. Although it may not in some cases be the full future system in terms of the ultimate TSM integrated environment, we believe that the progress made thus far is essential. We cannot wait until TSM is fully implemented at a point in the future to be more responsive to the public, to satisfy the problems, and to improve the system incrementally over the years.

That is probably a substantial amount of the issue as it relates to the GAO observation—whether we are building the ultimate system and putting all of our resources there or transitioning the existing system by moving through a series of phased steps to get to where we will go with TSM at approximately the year 2000 to 2001.

Chairman JOHNSON. Thank you very much for your presentation, Mr. Westfall. It was very interesting.

In thinking about modernization and the presentation that you just made, I was interested in a letter that came to my attention recently from Commissioner Richardson's predecessor to my predecessor, Mr. Pickle. In it she comments that in 1990, they identified 128 fraud schemes affecting 411 returns. This is all in regard to electronic filing. Since that is clearly one of the directions you are going and must go and have begun to get people together to focus on how to eliminate fraud, I am curious that as early as—her letter is 1992—she comments that in 1990 there were 128 fraud schemes affecting 411 returns against a population of about 4 million returns filed electronically. In 1992, just 2 years later, they projected that they would identify 1,400 fraud schemes affecting 12,000 returns against a population of 11 million electronically filed returns.

You are now up to 16 million returns.

As you have developed your system, have you worked from that base of fraud schemes that the IRS identified early? How has that work gone? Why is it that, in spite of that work, we should be up to such extraordinarily high rates?

My understanding is that 43 percent of all fraud is committed via electronic returns and that 90 percent of the EITC returns are involved. I may not be remembering these figures accurately. I am not claiming they weren't given to me accurately. I may not be restating them accurately, but the implications are certainly there.

Ms. RICHARDSON. I think, Madam Chairman, as we developed TSM—and one of the reasons it is so important, I think, that we move ahead with modernizing our system—is that it will provide us the ability to prevent fraud and prevent fraudulent returns from entering into the system.

We can come back to that in just a moment.

I think it is fair to say that not finding fraud does not mean that it doesn't exist. As your ability to detect it becomes more sophisticated and better, you find more fraud and that is—so sometimes finding more can be a good sign because it at least means your detection capabilities are working.

Our goals, as we stated 1 year ago and will continue to be, were to understand enough about fraud and the patterns of fraud so we could build into our systems, as a stopgap from here to the end of this decade, filters for screening out potentially fraudulent returns, questionable returns, and also to take steps that we could build into our ultimate system the ability to prevent fraud.

Mr. Brown, who is with me today, is our refund fraud executive; and I know he would be happy to answer more specific questions. He has been a person who, for almost 2 years now, has overseen our capabilities, not just working with each filing season, but also working with our modernization people to assure that we have long-term solutions to fraud built into our TSM plans.

Chairman JOHNSON. We will get into fraud issues more specifically later on, but——

Ms. RICHARDSON. I think the important thing to remember is that it has really been the advent of electronic filing and electronic processing of information that has allowed us to detect patterns of fraud, and it is important that we continue being able to process even those paper returns electronically, as Mr. Westfall was demonstrating, so that we can detect patterns of fraud. We are much better able when we have access to full return information to detect and then ultimately prevent fraud.

Chairman JOHNSON. Later on, as we do get into a discussion more specifically of fraud and prevention, it would be useful to us to have more detailed information about what kinds of patterns you have detected in the past. I would ask you about the work you are doing now and tip off those who you might be after, but there are a number of issues in the fraud area that we want to go into in more depth. But, at this point, I am going to yield to my colleague, Mr. Matsui from California.

Ms. RICHARDSON. I think the real important thing to remember is with a more modern system and better capabilities built in through the electronic filing and processing systems, we will be in a better position to address fraud.

Mr. MATSUI. Thank you, Madam Chairwoman.

I have a question directed to the Commissioner from Representative McDermott who is not able to be here today. May I direct this to the Commissioner and perhaps the Service can answer it.

Chairman JOHNSON. Certainly.

Mr. MATSUI. I want to make two observations before I ask a question of Mr. Westfall, one is that I have not really kept up with the tax system modernization program. This is my first year on the Oversight Subcommittee and so my support of it is, basically, upon the representations of the Commissioner who I greatly respect in this area.

I would like to ask Mr. Westfall some questions, however, regarding it. You have indicated, in response to the question from the chairwoman, that you have been doing this now for approximately 4 years, this TSM system?

Mr. WESTFALL. I think what I indicated is that in this particular tour I have been back here in the Washington office for 4 years. I have served as program manager for TSM since last June when the Commissioner announced the major change in how the program would be managed for the future.

Mr. MATSUI. Now, it is my understanding—and I have only started really getting into this by reviewing the GAO document and also the testimony today and some documents from the staff—but I understand since approximately the mideighties this program has been kind of conceptualized by the IRS. Is this correct?

Mr. WESTFALL. That is correct.

Mr. MATSUI. You were not involved in it at that time?

Mr. WESTFALL. I was involved in it only as an executive in the field who was interested in modernization and had input into the original formulation.

Mr. MATSUI. But it wasn't until the early nineties that we really started getting into this program and actually coming up with a scheme, is that correct?

Mr. WESTFALL. That, essentially, is correct, yes.

Mr. MATSUI. OK. Now how many managers have been involved in this since then?

Mr. WESTFALL. The program for the most part——

Mr. MATSUI. You?

Mr. WESTFALL. I am the first program manager for TSM in the form that we have it today. The program was previously managed by the CIO (chief information officer) more as a technology agenda. It has become a business agenda in a very large sense, and so the CIO and that large information systems organization remains very, very active and dominant in a lot of this, but it has now come under the management of a business approach.

Mr. MATSUI. Because prior to your taking over, which is a few months ago, this was basically setting up the system conceptually and on paper, is that correct?

Mr. WESTFALL. A lot of the original investment was in that, yes, but there have also been systems delivered as early as 1992.

Mr. MATSUI. OK. One of the criticisms that the GAO has is that there is a lack of vision in what you are trying to do, and I am trying to understand this from your graphs. I can think of three reasons why you want to do this—and you probably can add more.

One is that everybody likes computers so why aren't you doing it? Two, the code has become much more complex over the last 15 years or so or 10 years or 5 years—whatever. It may be you need a computerized system in order to deal with it. Three, of course there is just an increase in the amount of work because there are just filings being done.

Now those three reasons—and it seems to me that what you have just described in terms of your system being put in place now it seems like you are talking about the easier returns. If somebody can do it over the telephone, it sounds like you can—that is a pretty easy one it seems to me.

Now, perhaps you can kind of explain when we are going to get to the more complex ones. Am I correct in my analysis so far?

Mr. WESTFALL. I guess the three rationales I would give for why we do this—stated a little bit differently. I think that we recognize that we have to be able to take actions within the tax system much faster than we take them today. The fact that it takes 6 weeks to get a tax refund, the fact that it takes us 1½ years to match information documents to verify that the information you claimed on your return was correct, these are actions that are terribly slow in the business environment of the country today. That is one.

The second is errors. Speed is one thing. Frequency of error is another. Because a paper return has to flow through a factory environment, be handled more than two dozen times between all of our handlings and those of the taxpayer before the return was sent to us, an error rate results of between 15 and 20 percent of the returns. To correct these errors is terribly costly and terribly unsatisfying both to us and to the public. We seek to reduce that error rate as much as possible, and in the electronic environment, it is less than 1 percent. Speed is one thing; error frequency is another.

The third is the fact that we don't have access to enough information to effectively administer the system. We seek to put much more information in our database and then electronically access that information in order that we can properly manage the account and be responsive to the public relative to the account.

Now, the 1040. I think I mentioned the form 1040 EZ as being a return that is currently capable of being filed over the telephone in some States now. That is a simple return. There is an enormous range of complexity across the whole return set, and we are moving incrementally with different approaches on different levels of complexity.

We are, for instance, taking 1040 returns, the more complex returns, through the electronic side of the system. But that particular return, it currently exceeds our complexity range for what we think we can effectively control and handle through a telephone approach. So there are different stage solutions in this for different ranges of complexity and types of documents over time.

Mr. MATSUI. OK. One last question. In terms of your management of putting the system in place and the oversight of it, are you using outside vendors as well or is this something that is all in-house? We are talking about $20 billion perhaps over the period of years.

Mr. WESTFALL. We are extensively using contract resources and consulting expertise outside of government, probably on a dimension that is pretty comparable to what the large defense agencies use in connection with some of their larger technology pursuits. The 1996 resource estimate that we make is that an excess of 75 percent of the budget in TSM would be expended for products and services that are contractor based.

This ranges from the fact that the Commissioner consults with the National Research Council on a personal basis to have them monitor and provide her consulting assistance relative to the program to the fact that the TRW Corporation acts as our integration support contractor on a long-range contract, the fact that the Illinois Institute of Technology serves us from a research and development consulting expertise, and then down to such things as a very large image and character recognition contract that will facilitate our paper processing for the future has been awarded to the Grumman Corp.

There are just a host of very, very large corporate entities that have various roles in the overall program. Yes, Loral Federal Systems is also involved in our document processing system development.

Mr. MATSUI. Thank you.

Chairman JOHNSON. Thank you.

Mr. Herger.

Mr. HERGER. Thank you very much, Madam Chair.

Commissioner, if you could tell us—now that the 1994 filing season year is 1 year old, could you tell us perhaps what the profile was for the refund fraud during 1994?

Ms. RICHARDSON. I guess one of the things that we are reluctant to do is to be too specific, because many of the filters and screens that we built into our system this year were based on what those profiles were.

About this time last year I think we testified to a number of different types of schemes in which people were engaging, but the specific profile I would be reluctant to talk about other than in a closed session because that really is how we determined what our filters would be for this year.

Mr. HERGER. Could you perhaps give us an idea of how much was involved with the paper returns and those filed electronically?

Ms. RICHARDSON. I am going to ask Mr. Brand if he might join us at the table. He is our chief compliance officer and I think has most of those numbers probably committed to his memory many times over.

The one thing I would like to say, though, a lot of the concerns did involve use of duplicate Social Security numbers, erroneous Social Security numbers, inaccurate Social Security numbers. So that has been a main focus of ours for this filing season, to encourage taxpayers—to urge taxpayers to use accurate Social Security numbers, not just for themselves and their spouses but also for their dependents.

Mr. BRAND. I might be able to size this a little bit for the subcommittee.

First off, last year during 1994 we believe what we identified were 77,000-plus fraudulent—actually fraudulent returns. I will

come back and talk about the difference a little bit between fraudulent and erroneous. About 33.6 thousand of these were ELF returns; 42.2 were, in fact, paper. So you see the spread between the types of—and, again, I am talking about outright fraudulent returns here. There was $160 million claimed in this amount.

Additionally, we disallowed another $450 million of questionable refunds. We haven't made a determination that they are fraudulent, but they are at least problematic because of some instance on the return or some result of correspondence. So we are talking someplace in the neighborhood last year of $567 million or $0.5 billion of this range that I talk about between fraudulent and erroneous that we, in fact, deleted last year.

There were 413 prosecutions last year for refund fraud that were actually prosecutions that occurred and, obviously, a number of starts of prosecution cases that will continue to occur as we come through the year. So that is sort of the way we sized what our part is. The problem is, about fraud, you only know what you detect, of course. You don't know what you don't detect.

Mr. HERGER. Well, knowing what you did detect, is there anything in hindsight that you feel we might have been able to have done differently?

Mr. BRAND. I think in hindsight what we tried to do, I guess, is take the hindsight and apply it to 1995.

One of the things we know to be very problematic, as the Commissioner mentioned, is this whole area of Social Security numbers—making sure that the Social Security numbers are present and they are correct, that they match up with the taxpayer, et cetera. So that is one of the areas that we have paid close attention to for this coming year.

Again, a number of the lessons that we have learned we would be glad to share with you, furnish you that in closed session because it does impact on the way that we detect fraud and also just abuse.

Mr. HERGER. OK. Maybe one other question.

Chairman JOHNSON. Certainly.

Mr. HERGER. A different issue, has to do—on page 9, Commissioner, in your testimony you stated that taxpayers should be able to get through to the IRS on the first call. I think it also mentions about how expensive it is through correspondence. Evidently, you are alluding to the fact that it is less expensive to be able to take care of these questions by phone rather than through correspondence.

Ms. RICHARDSON. Our goal is for people to be able to get through on the first call and, ultimately, to handle 95 percent of the account inquiries in that telephone call on the first call.

Right now, if you were to receive a letter from us that said we have a question about a deduction that was claimed or something may have been omitted, we would send you a letter. You could write back to us. Perhaps before you got back to us a second letter might have gone out. So, in the meantime, interest and penalties might be building up on an amount. The correspondence crosses in the mail; a check crosses in the mail because we don't have the capacity today to do online posting of accounts.

It isn't like your being able to call your credit card company or your bank and if there is a question about your account, you can resolve it typically right there on that telephone call. We can't do that today.

Mr. Westfall mentioned 15 to 20 percent of our paper processing or paper returns end up with errors. If you apply 15 to 20 percent against 100 million paper returns, that is a lot of errors, a lot of contact; and it is a very labor intensive process.

We feel like if we can handle that account question or handle that account matter over the telephone and resolve it right there, we have probably saved ourselves a lot of correspondence but also, ultimately, maybe some compliance issues down the road which are also expensive if you have to have a revenue agent or revenue officer involved.

Mr. HERGER. Now GAO says that the chances of a taxpayer getting through to the IRS on his phone call is only 13 percent—in other words, less than one in five times——

Ms. RICHARDSON. That was based on weeks earlier in this filing season. We don't have precise agreement, I think, with the GAO about how you measure access to our system but, in any event, it was based on a 1-week look early in the filing season.

Mr. HERGER. That 1 week was less than one out of five times they were able to get through to you. Is it——

Ms. RICHARDSON. I think it was based on a number of calls placed, not the number of taxpayers who got through. We actually use a system, the unique number report, with which you can identify where people have actually been able to get through on a system.

Mr. HERGER. So you are saying that that 13 percent is not characteristic of——

Ms. RICHARDSON. Correct, it is not characteristic of what we are experiencing at this point in the filing season.

Mr. HERGER. What would you say it is at this point? Thirteen percent, I am sure, we all have to agree, is certainly something we have to improve quite dramatically.

Ms. RICHARDSON. I am sorry. It is averaging around 50 percent, which our goal for this filing season was to try to answer 52 percent of the calls—of the taxpayers' calls. That is basically what we feel we are able to do based on what funding levels we had for our taxpayer service function. We are running about at that level now for the season.

Mr. HERGER. I was speaking with a CPA only in the last week who indicated that—and I don't know where his statistics came from—two-thirds of the answers that they did receive when they did contact the IRS were correct. One-third were not. One out of three were not correct, and yet that taxpayer was held responsible—accountable for that one-third that weren't correct. Would you like to comment on that?

Ms. RICHARDSON. I would. I think that our numbers show that our accuracy is a little bit higher than that. Our goal is to have it—I mean, obviously, you would like to have 100 percent, but I think we have been running right around 90 percent the last couple of years, and we expect to have that same standard for this year as well.

Chairman JOHNSON. Excuse me, Commissioner. Is that 90 percent accuracy?

Ms. RICHARDSON. Correct. There are some areas, quite frankly, that are gray.

Mr. HERGER. Is there a reason why—now 90 percent is certainly far better than 66 percent, but yet is there some reason why a taxpayer should not be able—is the system so complicated that we can't be answering correctly almost, say, 98, 99 percent?

Ms. RICHARDSON. Our goal—we would like to be able to answer every single question accurately.

Mr. HERGER. Is there some allowance that is given during this——

Ms. RICHARDSON. I was going to say we published this year in the tax package for the first time our customer service standards, and if a taxpayer can demonstrate that any penalties or interest are imposed because of an erroneous answer they have received from us, we will be in a position to not charge them with that.

I agree with the premise of your earlier question. People shouldn't be penalized if we have made a mistake.

Mr. DOLAN. Mr. Herger, if I might amplify slightly.

We have watched the quality of taxpayer service operation very intensively for the last 4 or 5 years. I think we report to this subcommittee and others quite regularly on a week-to-week monitoring process where we watch every site for their individual quality performance.

We break it down into three particular areas: the technical tax law answer, the quality of answers on procedural questions, and the quality of answers on account questions. We give immediate feedback to the sites who show any slippage. We have put in place a very standardized probe and response guide so when you call in to site 1 or site 13, you ought to be received the same way.

We go through, basically, the same algorithmic approach to getting the right answer to the taxpayer; and we have tried to make a passion out of offering a quality service.

As the Commissioner said, the last couple of years on the filing season basically it averaged 90 percent. Last week's results were 86 percent. We would like that to be higher, but we are also doing a tremendous amount of reconfiguration this filing season and putting our people to probably as much challenge as we have in the last 4 or 5 years to be onsite and be prepared to give a quality answer.

Mr. HERGER. Thank you.

Chairman JOHNSON. Mr. Hancock, we will have to try to move along because there are a number of other issues to cover with the Commissioner.

Mr. HANCOCK. Just a real brief question—I think it will be brief, anyway.

I noticed in the testimony that on the accounts receivable and uncollectibles, the percentage that you are collecting hasn't been going up very much. I also noticed in 1990 you had roughly 87 billion accounts receivable, now there are 156 billion, which is an 80-percent increase. As a small businessman and a business advisor, accounts receivable is one of the things that you look at real quickly.

Ms. RICHARDSON. Absolutely.

Mr. HANCOCK. I am wondering what your projections are. Are we going to continue to see these increases? I would think that you would have this broken down into ages and what have you, just like a business would. I wonder if we might be able to get that information, the numbers of accounts and the age on them like a business would?

Ms. RICHARDSON. Absolutely.

Probably the biggest single factor contributing to that dramatic growth was a change in the law that required us to keep accounts receivable on the books for 10 years instead of 6 years. So, unlike a business and ones that you probably are most familiar with where you write them off after a certain point when people are dead or bankrupt or whatever, we are not in a position to do that. But we do have that breakout and can get you that information.

Mr. HANCOCK. Pardon me. You mean if you find that this individual is no longer around and that the estate is settled, you still have to keep it on the books?

Ms. RICHARDSON. Yes, sir. We can break it out in great detail because it is not the way you would keep your accounts receivable in a business day in and day out—at least in a realistic way. But the largest single increase has been attributable to the fact that we had to account for them or keep them on the books for 10 years.

Now the 10th year is just ending this year, so next year you will see a different number. We are working to try to enhance collections and collect those amounts that are collectible. But there are some things that are carried in that figure that are not collectible and will never be collected, and we would be happy to give you a very detailed breakdown of that.

Mr. HANCOCK. Thank you.

Thank you, Madam Chairman.

[The following was subsequently received:]

Breakdown of ARDI Statistics

In 1990, Congress extended the time the IRS is required to keep accounts receivable on the books from 6 to 10 years. Thus, unlike businesses in the private sector, IRS accounts receivable cannot be written off even if they are not collectible. This change alone increased IRS accounts receivable by 20%. The Accounts Receivable Inventory carried by the IRS is not a reflection of an annual underpayment of taxes, but includes current receivables, plus a ten year carryover of unpaid taxes, along with accrued interest and penalties.

At the end of FY 94, IRS gross receivables equalled $156 billion, of which 30% or $46.8 billion reflected accrued interest and penalties. At the end of FY 90, gross receivables were $87 billion. The IRS gross receivables, like the receivables of a private business, are divided into two components: (1) currently not collectible; and (2) active accounts receivable. An analysis of these two categories as of the end of FY 94 reflects:

- Currently Not Collectible (CNC) - $76.5 billion is currently not collectible; 38.3% ($29.3 billion) of this amount is comprised of accrued penalties and interest. Over 86% ($65.79 billion) of the CNC inventory is not collectible due to defunct (no asset) corporations; bankruptcy (after adjudication by the bankruptcy court); hardships; or the taxpayer did not respond to contacts or could not be located.

- Active Accounts Receivable - $79.5 billion is potentially collectible. Of this amount:

  - 20.7% ($16.46 billion) is comprised of accrued penalties and interest;
  - 18% ($14.5 billion) are lower value cases that will be collected through systemic monitoring;
  - 18.4% ($14.63 billion) of the inventory is inactive, either awaiting adjudication by a court of acceptance of an offer in compromise;
  - 13.6% ($10.81 billion) are reported by notices;
  - 42% ($33.4 billion), the largest portion of the active account has been assigned for enforcement action.

In FY 94 alone, the IRS collected $1.2 trillion in net tax receipts. Also in FY 94, the active accounts receivable increased 7% ($5.1 billion), the smallest growth in active accounts receivable in 4 years.

Chairman JOHNSON. Just to pursue that, what about the more recent years? I mean, there is a way of factoring out—you have the 6- to 10-year problem. In the last 3 years have you increased the amount of uncollected taxes you have been able to collect?

Mr. BRAND. Let me give you a little bit of overview.

Chairman JOHNSON. This also goes to the figures that we have before us about erratic audit numbers.

Mr. BRAND. Let me give you a bit of overview, if I can, of the accounts receivable that Mr. Hancock referred to. About $79.5 billion of that is currently under active collection. The other portion of that has been determined as uncollectible. It has either been adjudicated as bankrupt, the taxpayer is deceased, we have contacted the taxpayer and determined there is some type of hardship or some type of reason not to make the collection—a whole variety of reasons there.

Over the past 3 years our collections, in fact, declined. However, we are really pleased about the fact that during 1994 and so far for the first 5 months in 1995, we had a substantial turnaround in terms of the portion of the accounts receivables that we are, in fact, collecting dollar amounts.

I think there is another thing to keep in mind when you look at accounts receivables and that is the fact that the percentage of accounts receivables to the total net revenues deposited to the Treasury of the United States has remained constant. We have been someplace in the area of 6 to 7 percent.

Accounts receivables in and of themselves are neither good nor bad. I think Mr. Hancock asked the magic question of what is the age of them and what is the collectibility of them, and those are the types of questions that we should provide for the record for you.

[The following was subsequently received:]

AGE AND COLLECTIBILITY OF ACCOUNTS RECEIVABLE

Our RACS (Revenue Accounting Control System) does not currently allow the IRS (Internal Revenue Service) to age the accounts receivable inventory. However, RACS is currently being redesigned to provide more accurate information about the nature of the accounts making up the receivables inventory. The IRS will begin implementing the redesigned system in fiscal year 1996.

At the end of fiscal year 1994, the active accounts receivable inventory was $79.5 billion. After taking into account an allowance for doubtful accounts, IRS estimates that $26.7 billion is potentailly realizable.

Ms. RICHARDSON. Madam Chairman, I think one of things that we can attribute the increased collections to is the fact that we applied additional staffing now to the issue. We have also taken some management steps which we can provide you for the record. As I mentioned in my testimony, from 1991 until the fiscal year we are in now, we actually have declined in staffing; and so some of that really has had its impact on the collections as well.

[The following was subsequently received:]

MANAGEMENT STEPS CONTRIBUTING TO INCREASED COLLECTIONS;
ARDI STAFFING STATISTICS

For the three years prior to FY 94, collection yield had declined between 4% and 6%. Although some of this decline was attributable to a decrease in front-line collection staffing, it was also the result of a decline in productivity. In FY 94, however, IRS' collection yield increased 3% with over a 9% decrease in front-line collection staffing. Through the first quarter of FY 95, collection yield has continued to increase by 3.8% over the first quarter of FY 94. When the hiring and training of the additional collection staff from the FY 95 Compliance Initiative is completed, the increase in yield should grow.

Management changes under way to improve collection include:

- Enhanced cooperation with state taxing authorities. The State Income Tax Levy Program involves agreements with states (Maryland, Virginia, North and South Carolina) whereby they accept IRS levies on state income tax refunds. This resulted in collections of $108 million from FY 92 to FY 94.
- Proper use of certain collection tools. In FY 92, the Offer in Compromise policy and procedures were streamlined resulting in additional collections of $281 million in FY 94 by enabling field personnel to finally resolve many accounts that previously would have remained uncollected. The use of seizures in appropriate situations. In FY 94, $125 million was collected from over 10,000 seizures, a 5.6% increase in seizure activity over FY 93. Effective use of levies resulted in $2 billion in revenue in FY 94. Expanding installment agreement authority to all contact employees increased the dollars secured through installment agreements from $2.28 billion in FY 92 to $4.75 billion in FY 94.
- Decreasing the number of notices, shortening the notice period and instituting earlier intervention by telephone. During FY 94, the IRS tested "early intervention" in two Automated Collection System (ACS) sites with positive results. In January 95, using 770 staffyears of the FY 95 Compliance Initiative in ACS sites, early intervention was implemented nationwide. We project, based on the experience during the pilot, that early intervention will results in additional revenues of $3 billion over 5 years.
- Increasing emphasis on and monitoring of payment of agreed tax assessments at the conclusion of the examination process. In FY 92, Examination secured payment of 8.1% of agreed tax assessments. In FY 94, as a result of the emphasis on payment at the conclusion of the examination process, Examination had secured payment of 31.7% of agreed tax assessments.

Chairman JOHNSON. Mr. Levin of Michigan.

Mr. LEVIN. Thank you.

Let me continue the Chair's discussion of TSM, and I very much agree with her that every hearing doesn't have to be entirely adversarial. We do have a stake in an IRS that collects. It is the basis of compliance. We want to be sure others pay. So let's focus for a few more minutes on the GAO report.

You have responded about marginal improvements, but they then go on to say that you seem to be focusing on automating old processes, and you need to focus better. They say they are concerned about potential management problems. You don't have the management skills to handle it.

By the time you do so, new systems will take over the present systems. All of us I think know about that. New processes occur faster than we can update our own. Again, you should direct your attention to a small number of projects that address critical gaps in mission performance.

Try to get to the nub of this. I am not sure—if you read your testimony and the GAO's report, it is really hard to understand what is the gist of all this. I mean, forget all the kind of fancy language. What are they saying and what are you saying in response?

Mr. WESTFALL. I believe that a significant amount of this issue goes to current systems improvements, as opposed to those that might be focused on the fully integrated solution. I will give you an example.

There is a system that is developed and basically, for the most part, is an automation of existing processes as opposed to being a major business reengineering endeavor. It is called the integrated collection system. That system is programmed, and it is prototyped and proven. We have spent money and would hope to continue to spend some amount of money in rolling that system out nationwide.

Now, in doing that, we don't do it recklessly. There is a nearly 10 percent productivity implication in that system going online based on the fact that having the access to a laptop and the information stored in laptop form when a revenue officer goes to the field significantly improves the efficiency of a revenue officer.

It has also been proven in prototype that a revenue officer, working in this automated environment and with access to the additional information as they work in the field, is producing more than 20 percent additional average revenue per case closed, per case worked. So not only are the cases being worked faster, but the revenue generation out of the cases is greater.

We have made a decision in that particular case that this short-term system is worthy of spending TSM funds, investing in the gains that are there today in that particular system as we move forward toward the ultimate system of the future.

That is an example I think of some of the contention—I believe GAO might assert. It might be an example of a system that they would view as not worthy of continuation; that they believe that our money would be better spent on the longer term TSM initiative. GAO can speak for themselves. I believe that is a fair translation of where they might come out on that particular system.

We disagree. We think we can't afford not to spend that money. We think that it is directly pertinent to where we want our collectibility to go for the future and is an appropriate transition step to take.

To get to the nub of the issue. I think it is a question of are you building the ultimate system or are you spending money transitioning your current system over time to where you want to go.

I believe GAO would have us go more to build a fully integrated system and dedicate and build resources. We agree we have to engage those resources and deliver that integrated solution. But, in doing it, we also believe that we have to improve operations today, especially with systems that are proven and already developed, and that we can make those systems consistent with the future.

For instance, these systems that we are putting online today, we are attempting to use hardware and, where possible, the standard approaches that will make that system as consistent with our ultimate vision as we can. We might have to throw the software away, but where we can, we want to at least be able to work the workstation in the longer term environment as we change.

Mr. LEVIN. I want to ask one other question, and I think we are now anxious to talk to the GAO. Unfortunately, we have these panels and you don't get people talking to each other who disagree. So let me just ask you, because we have such a stake in this, I think if any system needs to be automated it is the tax filing system, right? I mean, there has to be more paper going through there than even here.

Now, do you talk to experts? I mean, are you—this disagreement about short term, long term, are you doing this of your own notions or are you consulting wise people outside? How are we supposed to sit in here and have any idea of who is right? We haven't heard from GAO yet, but what are we supposed—there is a lot at stake here. So you talk to people before you do these things?

Ms. RICHARDSON. We most definitely do. I wanted to mention that Mr. Bowsher, the Comptroller General, and I will be meeting some time this week to really talk about what the facts are, what our differences are, if any, and where we can go about reaching common ground so we can move on with this together.

We very much appreciate the oversight role of the General Accounting Office, and I think it is important that we have oversight. I have engaged the National Research Council to help us. That is part of the National Academy of Science, National Academy of Engineering. We have a number of people from the private sector who sit gratis on a panel to help us with this. As Mr. Westfall testified, we are using a number of outside contractors as well.

I think it is important that we all do work together to accomplish this goal because good tax administration is vital to this country. It has nothing to do with political issues or anything else. It is terribly important that we work together.

So our staffs actually met last week primarily to talk about some of the issues. We are going to be talking about what we can do. I think it is only fair that we keep you apprised of where we are because, obviously, you all do not have the time to get into these matters as deeply as we do, and I don't have as much time as Mr.

Westfall does to get into these matters. We want it to work. We want it to work well. I think we will be working with the GAO to try to find out how we can make this system work.

Mr. LEVIN. Do you report back to the Chair after your discussion?

Ms. RICHARDSON. Most definitely.

Chairman JOHNSON. We may get ourselves all together to talk about that after they have discussed it.

Ms. RICHARDSON. The other thing I would like to say is that part of the disagreement may well be in whether or not you are here in the Dark Ages and have people using a pen and paper to do their work when you know that the ultimate system is going to look somewhat different in the year 2001. But there are tools such as these laptops that can make our people more productive, more effective, raise additional revenues. Should we sit here doing nothing for the next 5 years or for the last 10 years doing nothing until we have an ultimate system in place?

I guess we felt that any prudent businessperson would say no. We have got to keep enhancing our productivity and enhancing the collections as we move along.

What we have tried to do is assure that the decisions we make are not decisions that are irrevocable or would mean that we have to throw out something altogether and start over. We are transitioning, as Mr. Westfall said, to our new system. You just aren't going to turn the switch on one day and have a whole new tax system. It is something—it is a massive system, and we have to transition to it. I think that is where a lot of the disagreement lies.

The idea about focusing more effectively is one that we do agree with. We do know we have to focus, and that is one of the reasons I did appoint Mr. Westfall to be the project manager—not just for the technological side but for every single thing in our organization that has to do with modernization.

The operations people report to him on this issue. The technical people do. We did not want a system that when it was built nobody could use, it didn't meet the requirements of our business people. That happens very often I think in the private sector as well as the public sector, and we didn't want that to happen.

Chairman JOHNSON. Thank you, Commissioner.

Mr. Ramstad.

Mr. RAMSTAD. Thank you, Madam Chair.

Commissioner, I appreciate your coming to my office.

Chairman JOHNSON. I am sorry. I was leaning forward, and I thought our colleague from Texas had left.

Mr. RAMSTAD. I would be glad to yield to my good friend from Texas.

Mr. JOHNSON of Texas. Go ahead.

Mr. RAMSTAD. I am not going anywhere, and I am sorry I was late because of a flight.

Let me just ask you, Commissioner, I know we have spent zillions of dollars in upgrading the computer capability at the IRS. If some of our colleagues have their way—I know the distinguished Minority Leader, Mr. Gephardt, was here a couple of weeks ago ad-

vocating a flat tax. Our Majority Leader, Mr. Armey, advocates flat tax. It is gaining momentum here in the Congress.

If the flat tax becomes law, a simplified card like this is used to file our taxes, and everybody does it at 11:30 on the evening of April 15, what about the computer resources? I mean, isn't this expenditure going to go for naught?

Ms. RICHARDSON. I don't think so. The reason is, no matter what system we have, whether it is an income tax, a consumption-based tax, and whether the income tax is flattened out or whatever, someone in some organization has to administer it. What we are doing today to bring us really into the 20th century—maybe not even into the 21st—is going to be vital no matter what kind of tax system you enact.

One of the biggest concerns I have, quite frankly, is that our system cannot be responsive enough to try to make the quick changes that we may be called upon to do. I think that—as I have encouraged everyone, both on the subcommittee as well as your staff, to join us at one of our service centers, especially this time of the year, I think you would really be amazed at how well the system works, not that we do have a few errors. I think it is important that we continue with this project because, whatever happens in terms of the tax law, we will need that upgraded and updated equipment to administer it.

Mr. RAMSTAD. For some reason, I am not surprised you didn't say we are spending too much money on computers.

Ms. RICHARDSON. Those postcards will be coming in. We will have to process those, too.

Mr. RAMSTAD. Let me ask you about the work force person power there. Now there are over 113,000 employees, and 5,000 additional employees were funded last year as I recall—$405 million per year for 5 years to fund 5,000 new agents to improve compliance and collections.

In view of the resources that we put into the computer system, are we at some point going to see a dividend in terms of decreased employees? Isn't there some correlation? The more you automate, shouldn't we see the need for employee decrease?

Ms. RICHARDSON. Absolutely. One of those charts that Mr. Westfall was showing indicates that from fiscal year 1992 through 1995, we have productivity savings of 11,000 FTE that we have given up as a result of tax systems modernization.

Now we have been given backstaffing, and I might add that 5,000 was on top of a 109,000 base, I believe. So we are now, I think, around 114,000 FTE.

It wasn't 5,000 on top of the 113,000 or 114,000. But, in 1992, we had 117,000 full-time equivalents. We have been able to enhance our productivity, and we will continue to do that.

But our customer base is growing, we hope. As we are taking on additional workloads with more filings, the population increases, and we need to be working on some of those compliance issues we talked about. We need to address the accounts receivable issue. So some of the increase in staffing that we would be looking to—not increase in staffing but some of the productivity savings we would like to reinvest in compliance-related positions.

Mr. RAMSTAD. So, really, you are not willing at this point to correlate the increased expenditures, increased appropriations for computers to at some point seeing a reduced work force.

Ms. RICHARDSON. I am sorry. We can do that. We have done that. We will give you the precise numbers of exactly what we can save as a result of what we have done and what we will be doing.

[The following was subsequently received:]

The following table provides additional documentation on the 11,819 cumulative FTE savings from automation achieved through FY 1995:

FY 1996 PRESIDENT'S BUDGET, FEBRUARY 6, 1995
CUMULATIVE PRODUCTIVITY SAVINGS
FY 1992-1995 (FTE)

	FY 1992 FTE	FY 1993 FTE	FY 1994 FTE	FY 1995 FTE	FY 92-95 Total
CURRENT SYSTEMS:					
ICS-Connectivity		303	303	303	909
Automated Workload Management System			98	98	196
Replace Automatic Call Distributors		101	101	101	303
Exam Laptop Replacement	0				
End of Extension to File Form		72	72	72	216
ICS Replacement			36	36	72
Sub-total, Current Systems	*0*	*476*	*610*	*610*	1,696
TAX SYSTEMS MODERNIZATION:					
Totally Integrated Exam. System (TIES)		116	505	993	1,614
Corporate Files On Line (CFOL)	423	782	1,054	1,054	3,313
Automated Underreporter (AUR)	148	385	654	782	1,969
Electronic Filing	479	634	634	634	2,381
Cash Management System (CMS)			3	385	388
Automated Criminal Investigation (ACI)					0
Counsel Automated Systems Environment (CASE)				67	67
Integrated Collection System (ICS)			36	36	72
Service Ctr Recognition/Image Process Sys (SCRIPS)			55	99	154
Telephone Routing Interactive System (TRIS)			61	61	122
Inspection Systems Development				24	24
Corporate Systems Modernization/Transition (CSM/T)				19	19
Sub-total, TSM	*1,050*	*1,917*	*3,002*	*4,154*	10,123
Total, FTE Savings	**1,050**	**2,393**	**3,612**	**4,764**	**11,819**

For the FY 1996-FY 2000 period, an additional 22,703 FTE of Tax Systems Modernization savings are projected based on full funding of the FY 1996 President's budget. These savings, which accrue by year, are proposed to be reinvested in compliance and detection activities made possible by the capabilities that TSM will provide. Additional revenue in the amount of $2.546 billion can be generated from this reinvestment for the same time period.

Mr. WESTFALL. We estimate, approximately, an additional 12,000 FTE over the term of implementing TSM that will be capable of being given up as backroom jobs—a lot of clerical positions, paper handling positions, control positions that can be—for which we will have a choice. The choice that you will have is either to remove those positions from our funding base or to authorize us to reallocate those positions into compliance jobs at a 5-to-1 or greater revenue generating capability.

One of the things we get out of TSM is a lot of new compliance opportunities that are generated by the additional information ability to analyze the information and, in the end, potentially apply some resources to work that particular compliance agenda.

Mr. RAMSTAD. Well, I appreciate your responses, and I certainly hope that the thrust is to reduce the Federal work force. I understand you have a difficult job and certainly as many critics as we do in Congress. IRS isn't everyone's favorite agency—I know that—but, nonetheless, I think all of us have to be very diligent in trying to cut expenditures as we are downsizing government. We need to do what the private sector has done for a long time.

I think it is clear the American people want us to reduce the size and scope of the Federal Government. It seems to me that, at least based on our visit and what you are saying now, that you are getting that message like all of us, hopefully, are getting that message; and we will continue to work toward that end.

Ms. RICHARDSON. Not only are we getting it, I think we got it at least several years ago.

In my testimony, I mention the fact that we are actually reducing the number. We now have 10 service centers. We are moving to five submission processing centers. So there will only be five centers out there where people will be filing their returns. We will have 3 computing centers instead of 12—10 service centers and 2 computer sites.

We are moving about a thousand employees out of our headquarters operation. I think over 500 are out now. By the end of the year, another 500 will be out on the front lines. The same with our regional structure.

We are in the process of looking at our district office and regional office missions and operations, and we will be making some recommendations later this spring about how we want to have those structured.

So we are acutely aware of the importance of using our resources wisely. We understand the importance of streamlining.

But what modernization has allowed us to do is to really reengineer the way we do our business. To be able to reengineer our business without having the technology to go along with it would really not, I think, be the prudent thing to do in terms of the tax administration system. The two do go hand in hand.

Mr. RAMSTAD. Thank you, Madam Chair.

Chairman JOHNSON. Mr. Johnson of Texas.

Mr. JOHNSON of Texas. I didn't mind yielding to my friend from north Texas.

I would like to ask a couple of questions. First, it seems to me that maybe we are reinventing the wheel taking so long—to the year 2008—to get this job done.

I am pleased to know that you are consulting with TRW. That is a good company, and they have just made a conversion themselves. They moved their equipment—they changed their whole computer system and moved the equipment in overnight without hampering customer service one iota.

I know in the Air Force it takes us 10 years to develop an airplane and here you are taking 12 years or more just to get a new computer system going. Can you explain that to me?

Ms. RICHARDSON. Well, I am going to let Mr. Westfall handle the more technical details, but this might be a good time for a plug about the Federal procurement process, too.

Mr. JOHNSON of Texas. Well, then let me ask you another question. Can you privatize this conversion and get it out of the government control? That is what you just said you could do.

Ross Perot used to say—and I don't quote him very often—he said, "Why don't you just pull it over to the side of the road, lift the hood and fix it?"

Ms. RICHARDSON. Let me say if we could have done it, it probably would have been done long before my watch, too. It is a massive undertaking. The year—really, I hope, before the year 2001—and I will let Mr. Westfall address that.

But I do think that when you talk about technology acquisition you need to have a long, hard look at what the procurement rules do. They were very well suited to the time when we were buying jeeps and tanks and things that weren't changing very rapidly, and it is a very fair system. A lot of people can put in their bids. But technology is rapidly changing, and we need to be able to respond much more quickly.

That has been part of the problem with the delays. We have an extremely competent contracting staff. We have done a very good job in the procurement area withstanding protests, and I think we have done as well as we could and probably better than most other agencies in terms of procurement process working with what we have today, but it is still cumbersome.

Mr. WESTFALL. We have awarded——

Chairman JOHNSON. Let me just say we do have a number of other panels, so we will have to try to keep the answers focused.

Ms. RICHARDSON. One thing I might add also. We would be more than happy to meet with you or meet with some of the members of the subcommittee—with Mr. Westfall.

Mr. JOHNSON of Texas. That is fine. I would like to know why it has taken so long.

Let me bring one more question into focus here before we quit. I am going to quote a quick paragraph from the Dallas Morning News which said, "According to wire reports, the IRS plans to collect credit reports, news stories, tips from informants, information from real estate, motor vehicle, and child support records as well as conventional government financial data. Aside from civil liberties concerns, citizens also fear the IRS is acknowledging that some of the data may be inaccurate but that taxpayers will not be allowed to review it or correct it."

Now I know in the case of TRW they do allow their consumers to correct their records, and I would hope the government doesn't get into that position. Can you tell me with a straight face that our

taxpayers are not going to be allowed to keep their records straight?

Ms. RICHARDSON. I can also tell you that that article was erroneous. There is—it was filled with significant amounts of erroneous information. I would be happy——

Mr. JOHNSON of Texas. But somebody in the IRS gave the press those reports.

Ms. RICHARDSON. Well, I think there is even dispute about how that was handled, quite frankly, but we are not collecting individual taxpayer information as they suggested. I can give you the specifics of what we are doing.

I had long conversations with Senator Pryor, and I know he is satisfied that we do have concerns about taxpayer's rights of privacy and the information we collect. I would be delighted to provide you with precisely what we were doing. The article was inaccurate in many, many ways——

Mr. JOHNSON of Texas. OK.

Ms. RICHARDSON. Not the least of which is——

[The following was subsequently received:]

Extent and Types of Information IRS Collects on Individuals

On December 20, 1994, the IRS published notice of an amended Privacy Act system of records: "Compliance Programs and Projects File - Treasury, IRS 42.021." Based on comments received and media articles, the notice may not have adequately distinguished among the various users and uses of the compliance system, as well as the data it is to contain.

The system will not be used to support large scale data matching in order to identify specific individuals for contact by IRS personnel. The IRS has developed procedural safeguards to prevent data used in the compliance research programs and projects that engage in large scale data manipulation techniques to determine levels of compliance in particular market segments from being used for enforcement purposes as to specific taxpayers.

The compliance research system is being redesigned to identify causes and trends of noncompliance and to generate and test new approaches to increasing voluntary compliance. The enhancements will not include maintenance of records with individually identifying information. The personnel who use and access the research system will not be enforcement personnel. The system will not be used to select individuals for enforcement actions.

This system of records has always on a limited basis and with legal authority contained information from various third-party sources. The enhancements to this system will add more information from more sources. However, use of these enhancements for the purposes of compliance research will adhere to the operating principles of such research: it will be group-focused rather than individually focused and not directly used to select individuals for enforcement actions.

Mr. JOHNSON of Texas. You don't like the GAO, and you don't like the press. Do you like anybody in Federal Government?

Thank you. I appreciate the responses.

Thank you, Madam Chairman.

Chairman JOHNSON. Thank you.

Mr. Zimmer will inquire.

Mr. ZIMMER. Thank you.

Mr. Westfall and Commissioner Richardson, as I walked by the Congressional Federal Credit Union on my way over here I saw their newsletter, and the headline says, get your tax refund weeks faster, and in the fine print it says up to 5 weeks faster if you file electronically.

My question is, if you are eligible for earned income tax credit, is that an accurate promise this year?

Ms. RICHARDSON. Yes, it is, if you are eligible for the earned income tax credit. If you are not, it is not accurate. We have been very concerned, as has this subcommittee in prior years, about people claiming a credit who are not eligible. There has been some fraud, and we have stepped up our efforts this year to police the whole refund program.

The vast majority of the people are getting their refunds in a timely fashion or timely in the sense of the customer service standards that we published. Only if people have questionable—or we have reason to question a refund or a credit claim are we holding it up.

Mr. ZIMMER. So what percentage of those EITC returns are being held up more than they were last year?

Ms. RICHARDSON. Mr. Zimmer—as of this morning we didn't have that information. I will be able to provide it to you, I think, in about another week.

[The following was subsequently received:]

Because the tax filing season is coming to a close, IRS does not yet have a final report on the number of EITC refunds delayed, but we will be happy to provide that report as soon as it is available.

Mr. ZIMMER. Is it a larger percentage? Because we understand from our constituents that it has gone up considerably.

Ms. RICHARDSON. It has certainly gone up over last year. As I said in my opening statement, I regret that there are people who are legitimately entitled to refunds and to the credit who are being caught in the initial screens and filters. But we have been very concerned about promoting integrity in this system and wanting to make sure that people who are eligible do get the credit and people who aren't don't.

One of the things that we have also encouraged is the advanced earned income tax credit which people can get throughout the year in their paychecks and wouldn't have to wait until they file their return to get at least the majority of the credit.

Mr. ZIMMER. At the end of your testimony, you said that you would appreciate it if we in Congress gave you some advance notice as to when we were going to change the Tax Code because of the impact it has on administration by the IRS. I certainly understand that.

Ms. RICHARDSON. We would certainly like to work with you.

Mr. ZIMMER. Obviously. That is a very good idea. But, by the same token, do you not feel that it is your obligation to inform taxpayers of a change in the procedures so that they can put their financial affairs in order?

There are a large number of taxpayers who applied for loans in anticipation of their refund. There were banks and other financial institutions that lent them the money, and now they find that a portion of the refund is being sent directly to the taxpayer by check—by paper check rather than by electronic transmission to the lender. This is not only a problem for the lenders but for the taxpayers as well.

If I get a check from the IRS, I am going to cash it. Sometimes my wife asks me what it is for, but I usually—the first impulse is to cash that check. That is money that is owed to the financial institution they borrowed from in anticipation of the refund. These taxpayers, by definition people of modest means, are really imperiling their credit rating as a result of that portion of the loan not being repaid.

Now, could you tell me what steps were taken in 1994 by the IRS to inform the taxpaying public and the relevant financial institutions that this change was about to take place?

Ms. RICHARDSON. Maybe you aren't aware, we are currently in litigation over many of the issues you have just talked about, so I am not in a position to comment other than fairly generally.

But, beginning even before the end of the filing season last year, as the concerns about refund fraud were voiced by this subcommittee, by other committees, the Treasury Department set up a task force; and we announced and worked with a number of the practitioner groups, the public.

Any time I have ever spoken and had the opportunity, I have indicated that we were going to be changing our procedures and processes for this filing season, that we would be taking whatever steps we thought would be prudent and appropriate to assure the integrity of the refund system.

In the tax package this year we indicated the importance of filing accurate information, accurate Social Security numbers and that we might have to do some compliance reviews on certain returns. So I think we have worked—my filing season press conference, we had a significant amount of publicity about the fact that we were going to be changing our approaches this year and stepping up our efforts.

So, as I said earlier, I am sorry that there are some people who have legitimate claims who are going to have their refunds held up, but we really do think it is important to promote integrity in the system.

Mr. ZIMMER. When did the IRS inform the public that it would issue some of the refunds in two installments, one that could be electronically transferred to the lender and the second is a paper check? When was that information made public?

Ms. RICHARDSON. I believe that was in December, perhaps.

Mr. ZIMMER. How was it promulgated?

Ms. RICHARDSON. I will have to get you the specific information. Again, this is a subject of a court proceeding and—but I will——

[The following was subsequently received:]

WAYS AND MEANS OVERSIGHT HEARING ON FEBRUARY 27, 1995

IRS Budget Proposal for FY 1996 and 1995 Filing Season

Insert for the Record

QUESTION: When did IRS highlight the bifurcation of refund returns?

ANSWER: Attached is a chronology dating back to 1992 that details the actions taken relating to the Revenue Protection Strategy. Highlights include activities in December 1994 and January 1995 that directly relate to bifurcated refunds.

QUESTION: Did the October 1994 notification covering elimination of the DDI also include notification of the bifurcated return system of the refunds that were going to be electronically filed?

ANSWER: The bifurcation of refunds was not discussed when we made notification of the DDI changes.

REVENUE PROTECTION STRATEGY

1992

October Commissioner and Deputy Commissioner, Assistant Commissioners (RP) and (CI) and Chief Counsel met with representatives from H&R Block, Beneficial Corp., Jackson Hewitt, Mellon Bank, Greenwood Trust, NATP and others to discuss plans to remove the Direct Deposit Indicator (DDI) in the 1994 filing season. The Industry presented IRS with a briefing document entitled, "The Direct Deposit Acknowledgement Issue and Its Relationship to Electronic Filing Fraud."

1993

April Banks submitted a supplement to the October 1992 paper entitled "Electronic Filing: Industry Led Initiatives to Combat Fraud and Improve Electronic Filing."

Creation of the Council of Electronic Revenue and Commerce Advancement (CERCA) to review security of data and privacy issues, and increase the value of electronic filing commerce with all agencies to ensure consistent standards of software and data elements.

June Deputy Commissioner, Assistant Commissioner (RP), Deputy Assistant Commissioner (RP), Director, Office of Refund Fraud and members of their staff met with industry representatives regarding the DDI issue.

IRS announced the decision to retain the DDI for the 1994 filing season along with steps to strengthen fraud detection/deterrence and expectations of the industry. Explained to industry that we will review this decision each filing season based on ongoing trends.

1994

June Presentation to CERCA on changes to Suitability, RAL advertising and Form 8453 requirements.

Refund Fraud Strategy approved by Treasury.

1994 (cont'd)

General Accounting Office briefed on fraud initiatives by the Director, Office of Refund Fraud.

July **IRS Nationwide Tax Forum - Baltimore (attendance 1,600). Opening executive remarks emphasized refund delays related to inaccurate SSNs. Seminar on 1995 Changes to the Electronic Filing Program emphasized importance of TIN accuracy for both paper and ELF. Seminar on Earned Income Credit - Advanced Earned Income Credit emphasized educating the public, compliance initiatives and future plans. Handout on preventing fraudulent filing, prepared by Fraud Task Group, provided to attendees. IRS Nationwide Tax Forum - Sacramento (attendance 1,150), same structure as Baltimore forum.**

Issued News Release IR-94-73 announcing new fraud control measures and need to verify the accuracy of SSNs prior to release of refunds.

August IRS Nationwide Tax Forum - Albuquerque (attendance 770), same structure as Baltimore forum.

IRS Nationwide Tax Forum - Kansas City (attendance 1,200), same structure as Baltimore forum.

Presentations to NAEA, ABA and NATP by the Director of Practice, discussing filing fraud initiatives, emphasizing DDI, SSN accuracy and refund delays.

Presentation to FTA Technology Workshop, including description of the Revenue Protection Strategy, ERO requirements, SSN accuracy and refund delays.

Presentation to North Eastern Tax Officials Association, including a brief overview of the Revenue Protection Strategy.

September IRS Nationwide Tax Forum - Orlando (attendance 2,000), same structure as Baltimore forum.

IRS Nationwide Tax Forum - Salt Lake City (attendance 690), same structure as Baltimore forum.

1994 (cont'd)

Briefing of SSA by the Director, Office of Refund Fraud and staff outlining filing fraud initiatives and potential impact on SSA, stressing coordination efforts.

Advance notification of ERO changes to states with joint electronic filing and national practitioner associations.

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Chief Compliance Officer interviewed by Associated Press and Washington Post reporters about the Revenue Protection Strategy. News Release IR 95-16 issued, urging accuracy to avoid

1994 (cont'd)

delays and addressing the potential for split refund payments on returns claiming tax credits. The news release was distributed to 43 representatives from general print media, technical tax press, electronic media, financial press and professional associations. The news release and Q&As, which addressed the split refund and second payment by check, were also made available on the ELF Bulletin Board and the Public Affairs Bulletin Board.

Subcommittee on Oversight, Committee on Ways and Means Hearing, "The 1995 Filing Season and IRS's FY 1995 Budget Request."

Mr. ZIMMER. This is a fact.

Ms. RICHARDSON. It was in December we put out press releases. We met with the people in the industry.

Mr. ZIMMER. Can you tell me why you send the second check as a paper check?

Ms. RICHARDSON. I can say that the taxpayer is entitled to the refund, and we send the refund to the taxpayer.

Mr. ZIMMER. But the taxpayer has requested that the entire refund go to the lender. Can you explain why you are disregarding the taxpayer's request?

Ms. RICHARDSON. This is the subject of a lawsuit so I have been advised not to discuss it.

Mr. ZIMMER. So you can't—OK.

At what point did you inform the public that you would delay refunds on so-called questionable returns?

Ms. RICHARDSON. Again, before the end of last year's filing season we said we were going to take steps to do that. Throughout all of our meetings last summer I think with the industry groups, from the time we began focusing on this issue, we made it very clear that we would delay refunds, take any other steps necessary to make sure that only the people entitled got them.

Mr. ZIMMER. How do you define questionable as in questionable returns?

Ms. RICHARDSON. I beg your pardon?

Mr. ZIMMER. How do you define a questionable——

Ms. RICHARDSON. Where, on the face of it, it appears that someone may not be eligible for a refund.

Mr. ZIMMER. How long a delay can a taxpayer anticipate if there is something——

Ms. RICHARDSON. Where we have held up the refund funds, we have sent letters to taxpayers informing them that it could be up to as long as 8 weeks.

Mr. ZIMMER. Do you have enough——

Ms. RICHARDSON. If there is additional information that we need from them, it may even be longer, but we are trying to process things as quickly as possible and get the money out as quickly as possible to the people who are eligible.

Mr. ZIMMER. Do you have enough experience to know how long the average delay is at this point?

Ms. RICHARDSON. We don't.

Mr. ZIMMER. OK. Thank you very much, Madam Chair.

Ms. RICHARDSON. Thank you.

Chairman JOHNSON. Thank you.

Mr. Hancock.

Mr. HANCOCK. Yes. I had a question asked to me over the weekend that I just remembered, and I figured that maybe we can get it on the record right now. This particular question was the State of Missouri now is requiring a copy of the Federal income tax return to be submitted with their State income tax return if it is itemized. The question is, since the Federal return is supposed to be confidential, can a State legally require a copy of the Federal return?

Ms. RICHARDSON. We will get you an answer.

I can tell you that the best advice I would take is, if I don't know the answer to the question, I will ask my lawyer and we will get back to you.

I know that a number of States use a Federal—because they piggyback onto the Federal tax system, ask you to file your schedule A or schedule B or whatever with your State return. I think that happens here in the District of Columbia and in the State of the Virginia.

Mr. HANCOCK. Can they require the entire 1040 return be submitted as part of a State return?

Ms. RICHARDSON. I think I really would feel more comfortable finding out and letting you know for sure.

Mr. HANCOCK. Thank you.

Chairman JOHNSON. Thank you.

[The following was subsequently received:]

The Internal Revenue Code neither authorizes nor prohibits a State from having such a requirement. In general, the rules of section 6103 of the code governing the confidentiality and disclosure of Federal returns and return information apply only to information that is submitted to the Federal Government. Therefore, States are free to ask for Federal tax return information directly from their taxpayers.

Section 6103(p)(8) of the code, however, was designed to ensure that States requiring Federal tax information directly from their taxpayers take steps to protect the confidentiality of that information. This section requires these States to adopt confidentiality laws before they can receive any Federal tax information directly from the Federal Government. Because information exchange with the IRS is very important to State taxing authorities, this provision has been an effective incentive for the States to adopt confidentiality laws that are satisfactory to the Internal Revenue Service.

Chairman JOHNSON. There are a couple of precise questions that I think we need to get on the record, Commissioner. We have strayed from the tax systems modernization program into the other areas that are of concern to the subcommittee, and that is acceptable, but there are a few more things we need to follow up on.

First of all, what were the consequences of the $400 million cut in your 1995 budget request for your tax system's modernization—in terms of your timetable for implementing the tax modernization system specifically?

Mr. WESTFALL. We are continuing to do—let me start this way. What we did when we took the major cut in the request that we made for 1995 is we did a complete reevaluation of where we were putting the money and how fast the systems were rolling out. We, basically, for the most part, have done some reprioritization, but geared the program down. The exact impact of what we have done is still somewhat uncertain.

We believe that we are probably slowed by a full year in the implementation of the program. How much of a delay or perhaps even program reductions have to take place will be a product of whether our 1996 request is authorized or not.

Chairman JOHNSON. Are you aware that the GAO believes that you will not be able to spend this year's money?

Mr. WESTFALL. I have read that in the GAO testimony. I believe that my response very clearly would be we will effectively spend the money.

We basically went on a hold last year as a result of the fact that the increase was not authorized. We have several major acquisitions in the system that are about ready to go to closure that re-

quire funds. The document processing system needs to be funded for rollout. That project has already been contracted. It may not be capable of being rolled out if funding is not authorized.

The largest single hardware acquisition in the system, the service center support system that provides the corporate hardware platform for the new database environment, is scheduled to be let very soon and is dependent upon funds that would be authorized in the 1996 budget.

Chairman JOHNSON. Thank you.

As to the tax filing season questions specifically, could you clarify for the record exactly when you did inform the public and the tax return preparers of your activities and your plans to curb fraudulent returns? Particularly your decision to be very strict about requiring accurate Social Security numbers. Did you inform clearly about that early?

Ms. RICHARDSON. I believe we did, Madam Chairman, and I can get you the specific chronology of when the announcements were made and what we said. That was clearly part of the tax package that went out to all taxpayers.

Chairman JOHNSON. I want to see if it was highlighted, since it was a change and since it was so important to our efforts to reduce fraud.

[The following was subsequently received:]

REVENUE PROTECTION STRATEGY

1992

October Commissioner and Deputy Commissioner, Assistant Commissioners (RP) and (CI) and Chief Counsel met with representatives from H&R Block, Beneficial Corp., Jackson Hewitt, Mellon Bank, Greenwood Trust, NATP and others to discuss plans to remove the Direct Deposit Indicator (DDI) in the 1994 filing season. The Industry presented IRS with a briefing document entitled, "The Direct Deposit Acknowledgement Issue and It's Relationship to Electronic Filing Fraud."

1993

April Banks submitted a supplement to the October 1992 paper entitled "Electronic Filing: Industry Led Initiatives to Combat Fraud and Improve Electronic Filing."

Creation of the Council of Electronic Revenue and Commerce Advancement (CERCA) to review security of data and privacy issues, and increase the value of electronic filing commerce with all agencies to ensure consistent standards of software and data elements.

June Deputy Commissioner, Assistant Commissioner (RP), Deputy Assistant Commissioner (RP), Director, Office of Refund Fraud and members of their staff met with industry representatives regarding the DDI issue.

IRS announced the decision to retain the DDI for the 1994 filing season along with steps to strengthen fraud detection/deterrence and expectations of the industry. Explained to industry that we will review this decision each filing season based on ongoing trends.

1994

June Presentation to CERCA on changes to Suitability, RAL advertising and Form 8453 requirements.

Refund Fraud Strategy Approved by Treasury.

General Accounting Office briefed on fraud initiatives by the Director, Office of Refund Fraud.

1994 (Con't)

July — IRS Nationwide Tax Forum - Baltimore (attendance 1,600) Opening executive remarks emphasized refund delays related to inaccurate SSN. Seminar on 1995 Changes to the Electronic Filing Program emphasized importance of TIN accuracy for both paper and ELF. Seminar on Earned Income Credit-Advanced Earned Income Credit emphasized educating the public, compliance initiatives and future plans. Handout on preventing fraudulent filing, prepared by Fraud Task Group, provided to attendees. IRS Nationwide Tax Forum - Sacramento (attendance 1,150), same structure as Baltimore forum.

Issued News Release IR-94-73, announcing new fraud control measures and need to verify the accuracy of SSNs prior to release of refunds.

August — IRS Nationwide Tax Forum - Albuquerque (attendance 770), same structure as Baltimore forum.

IRS Nationwide Tax Forum - Kansas City (attendance 1,200), same structure as Baltimore forum.

Presentations to NAEA, ABA and NATP by the Director of Practice, discussed filing fraud initiatives, emphasizing DDI, SSN accuracy and refund delays.

Presentation to FTA Technology Workshop, including description of the Revenue Protection Strategy, ERO requirements, SSN accuracy and refund delays.

Presentation to North Eastern Tax Officials Association, including a brief overview of the Revenue Protection Strategy.

September — IRS Nationwide Tax Forum - Orlando (attendance 2,000), same structure as Baltimore forum.

IRS Nationwide Tax Forum - Salt Lake City (attendance 690), same structure as Baltimore forum.

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Subcommittee on Oversight, Committee on Ways and Means Hearing, "The 1995 Filing Season and IRS's FY 1995 Budget Request".

Chairman JOHNSON. In the same vein, when did you highlight the bifurcation of the return in the refundable area?

Ms. RICHARDSON. I will get you that specific information.

Again, that——

Chairman JOHNSON. When you notified people and the tax preparers and what kind of advanced notice they actually got.

Ms. RICHARDSON. That specific issue is the subject of a pending lawsuit right now.

[The following was subsequently received:]

Although the potential for two payments was discussed at a meeting with the Commissioner's advisory group in September 1994, information about split refunds was first discussed in a more public forum in the Commissioner's press conference to kickoff the filing season on December 28, 1994. Questions and Answers, including information about issuance of a paper check for the second portion of the refund, were placed on the Electronic Filing Bulletin Board in conjunction with the press conference. (See our previous submission for the chronology of activities.)

Chairman JOHNSON. On a more general plane, going back to your predecessor's letter, which I did not pursue because I thought we would focus first on tax modernization systems, but Commissioner Peterson's letter did go on to very specifically say that in 1994 they would eliminate the DDI (direct deposit indicator).

Now the DDI does seem to be a real culprit in encouraging fraudulent returns and payment of returns in a way and at a pace that makes it very hard for us to retrieve the dollars if they are mistakenly paid.

I understand that your bifurcated system is responding to this, but why did you not just implement the recommendation that had been developed in the IRS to eliminate the DDI, which probably would have solved the problems rather more directly and with less complexity than the bifurcated return?

Ms. RICHARDSON. We did, and last October Secretary Bentsen announced that we would no longer be issuing the direct deposit indicator, and we are not doing that for this filing season.

Chairman JOHNSON. But you did do it for the 1995 filing season. I must have not expressed myself clearly. The original recommendation was for the 1994 filing season. Why was it delayed a year?

Ms. RICHARDSON. I was actually—I did not make that——

Chairman JOHNSON. If it is a transition thing, you may want to yield to one of your——

Ms. RICHARDSON. I did not make that decision at the time, but what we really wanted to do was get an opportunity to look at, as we testified here last year, to take a very principled approach to looking at the fraud, to trying to define what it is before we made any decisions.

Chairman JOHNSON. I agree with that. I do think this is an important point. Because clearly the IRS had determined that there was a real explosion in fraud going on, and that eliminating the DDI would help. I am concerned why that decision was delayed a year and any light you can shed on that would be very useful for us. Because, of course, millions of dollars went out that we will never recoup because the decision was delayed a year.

Mr. DOLAN. Madam Chairman, one of the perspectives I might add is that I participated over a series of about 3 years in a number of discussions both—basically across the constituency base of

practitioners, financial industries, others who are involved in this issue. What we had said as an organization from the outset was that we would continue to reevaluate both from filing season to filing season and within filing seasons.

One of the things the industry did in response to a meeting in 1993 was to suggest that the upstepped measures they would take in an industry-financed fraud service bureau would in fact eliminate the issues that the IRS had problems with. We said we would evaluate that. We said we would on a continuing basis determine what effects that other kinds of external stimuli might have had on the fraud.

Probably the time we had the most comprehensive picture of the fact that many of these cures, albeit well-intentioned, had not had the desired outcome was when we were able to do the two statistically valid studies that ran concurrent with the early months of the last filing season. It was coming out of that experience that we were convinced some of the anecdotal evidence and some of the suggestions that systems that had been interposed were going to make a difference in fraud had really not, that we made the judgment that the DDI was as integrally connected to what we were finding as we did.

Chairman JOHNSON. So are you saying that the original decision by the IRS to eliminate the DDI for the 1994 tax season—because this letter to my predecessor, Mr. Pickle, is very specific. It says we plan to eliminate the DDI beginning in the 1994 filing season. Later on it says to provide the time necessary for the discussion with the stakeholders, with other people involved in the system, we will not make the change in the DDI until the 1994 filing season.

So, clearly, this is going on well in advance of that filing season because they are delaying the decision in order to have the discussion with other people involved. With all of that preparation it did not go forward.

Now, you appear to be telling me that information gained from that very filing season indicated that maybe the DDI was not exactly the problem and maybe there were other answers that would be more effective. But that does not explain why the decision was derailed in apparently late 1992–93.

Mr. DOLAN. I am not sure, Madam Chairman, I can speak to all the circumstances that might have been behind the assertion that Commissioner Peterson made in that letter. I do believe that what had been going on and has gone on up until very recently is an active dialog among all the players in this arena with, we believe, the common objective of reducing the amount of fraud.

At almost every juncture steps were taken both by the IRS and by the many, many people in the industry to attempt to minimize the fraud. But on the heels of all those efforts, and given the additional information that came in last year, we believed that the Secretary made the right decision when he concluded, based on our advice, that the correlation was so strong. I think that additional information that came about as a result of early last filing season was what I think carried it over the top, at least from my point of view.

Chairman JOHNSON. Perhaps you, then, could tell me exactly when the IRS did inform people of these changes? The Commissioner referred to the tax package that went out to all filers.

Ms. RICHARDSON. No, I am sorry, on the removal of the direct deposit indicator, or the decision not to provide it any longer, that was made in October. I believe it was toward the end of October of last year by Secretary Bentsen. We can get you the precise date. That was announced at a press conference and widely publicized and the public record is quite—there are people that had a direct interest in it that we actually called and told them that the announcement was being made, but it was also announced to the public by the Secretary at the end of October.

Chairman JOHNSON. At the end of October.

Ms. RICHARDSON. Yes, ma'am.

Chairman JOHNSON. Thank you very much.

Are there other questions from the subcommittee? Yes, sir, Mr. Johnson from Texas.

Mr. JOHNSON of Texas. Thank you, Madam Chairman. I would just like to bring up the issue of the overseas assistance and tours that your department does, which is to some of the more exotic places in the world.

You answered the question about the Service's estimate of additional tax revenues that have been or will be collected by the Federal Government directly attributable to the program, and you say there is no data available to estimate the additional tax revenue attributable to overseas taxpayer assistance.

It would seem to me if we do not know that we are making money, if we do not have a cost analysis, then we ought to stop the program.

Ms. RICHARDSON. I would like Mr. Brand to maybe address that because he has the international operation under his——

Mr. JOHNSON of Texas. Thank you.

Mr. BRAND. Mr. Johnson, I would say this; that we assisted 95,000-plus taxpayers at a cost of $265,000 for travel.

Mr. JOHNSON of Texas. What is the total number of taxpayers in this country?

Mr. BRAND. Two point two million taxpayers are overseas and about half of these are, in fact, military taxpayers that we in fact assist there.

Mr. JOHNSON of Texas. So you saw a very small portion of them, actually.

Mr. BRAND. One could look at that and say that, yes, 1 million out of 2.2 million assisted.

Mr. JOHNSON of Texas. You have volunteers in the military and State Department that help you, do you not?

Mr. BRAND. Part of the purpose for the overseas travel, is, in fact, to train those volunteers, yes, sir.

Mr. JOHNSON of Texas. It would appear to me in some of the instances that you were spending hours, 1 or 2 or 3 hours, with very few people, in some cases. Others you had more there, I would agree.

Mr. BRAND. That is one of the things that you do on an annual basis, is you do probe and look to where there is in fact demand

and where there is in fact need and you change your service on a yearly basis depending on where in fact the need exists.

Mr. JOHNSON of Texas. Well, there are a lot of small countries where there are not any Americans, and I would say we should look at that program. Do you respond just because some Ambassador asks you to come?

Mr. BRAND. No, sir. I think the context here is IRS has been offering overseas assistance at this minimal amount for some 20-plus years. We respond based on where the U.S. Ambassador pleads there is demand, where we see demand, where our own historic record demands exist, and based on where the number of U.S. service people are stationed or where there are other Americans for various——

Mr. JOHNSON of Texas. Well, it seems to me if this thing has been around for 20 years, maybe you should look at that. I notice you have a request from the Ambassador in Haiti to send people down there. Is that a necessity?

Mr. BRAND. I don't know about the request, Mr. Johnson. I would have to take a look and see about a request to Haiti. But, in fact, there is a sizable military presence in Haiti right now.

Mr. JOHNSON of Texas. But the military helps you with their own people. I have been in the military, and I know. I never talked to an IRS person. They never helped at all.

Mr. BRAND. I understand. I hope that is not the case, but, in fact, in our interaction with the military, we are not there to do the direct assistance. We are there to train the individuals who act as volunteers to do the assistance.

Mr. JOHNSON of Texas. Then most of them are in the finance area of the military or the State Department, for that matter. So they rotate back to the United States on occasion. It would seem you could grab them then.

Thank you for your response.

Chairman JOHNSON. Commissioner, in October, you notified the public about the elimination of the DDI. Did you also notify them about the bifurcated return system of the refunds that were going to be electronically filed?

Ms. RICHARDSON. Madam Chairman, I will have to get you that for the record. I am not sure of the precise dates of that.

Chairman JOHNSON. I want to be sure that the notification in October was to all three points.

Ms. RICHARDSON. I am sorry, no, it was to the direct deposit indicator. That was when it was withdrawn in October.

Chairman JOHNSON. But it did not go to the whole system of reforms that you were going to apply to this tax filing period, and to the bifurcation of the refund in the electronic area and also to the second check going directly to the taxpayer. Was that information out there publicly in October?

Ms. RICHARDSON. I don't know exactly when it was out there. I know it was out there by the end of the year. I will get you the precise dates. I have to apologize because we had met with the industry and talked to them about what we were doing.

Chairman JOHNSON. Thank you very much.

[The following was subsequently received:]

The bifurcation of refunds was not discussed when we made notification of the DDI changes. (See our previous submission for the chronology of activities.)

Chairman JOHNSON. Since the EITC was involved in 90 percent of the fraudulent claims in 1994 and because in 1995 the number of people eligible to claim EITC benefits will increase by 6 million, I congratulate you on doing something about the problems in this area. We will follow the effects of your policies very closely, and we will be interested to see if they have any implications for changes in tax law, both in regard to the EITC and in regard to refundability in general and in regard to your process as well.

Ms. RICHARDSON. Again, we would like to work with the subcommittee and the subcommittee staff on any of those proposals.

Chairman JOHNSON. Thank you. I am going to recognize now Mr. Herger for one last question for the record.

Mr. HERGER. Thank you, Madam Chair. I do have another question that with your permission I would like to submit and submit to the Commissioner.

Chairman JOHNSON. Thank you. You certainly are welcome to do so, Mr. Herger, and thank you, Commissioner, and your staff, for your time this morning.

[The following was subsequently received:]

RESPONSE TO OVERSIGHT SUBCOMMITTEE OF THE COMMITTEE ON WAYS AND MEANS REGARDING TAX TREATMENT OF ASSOCIATE MEMBER DUES INCOME RECEIVED BY TAX-EXEMPT FARM BUREAUS

INTRODUCTION

During the House Ways and Means Oversight Subcommittee hearing of February 27, 1995, on IRS Budget Proposal for FY 1996 and 1995 Tax Return Filing Season, Congressman Herger requested that the Commissioner submit additional comments for the record. Congressman Herger requested information relating to a Technical Advice Memorandum issued in 1994. Specifically, the Commissioner was asked whether any change in IRS position evidenced in the 1994 TAM should "come only after careful review at the highest levels." In addition, the Commissioner was asked to provide any other thoughts regarding this matter.

The Technical Advice Memorandum (LTR 9416002) (1994 TAM) involved a farm bureau and the treatment of income derived from the dues of associate members. The 1994 TAM concluded that dues income from associate members resulted from the marketing of access to an unrelated trade or business (i.e., auto insurance) and thus was taxable to the organization.

LEGAL BACKGROUND

Income received by labor, agricultural (including farm bureaus), or horticultural organizations is generally exempt from federal income tax under section 501(c)(5) of the Internal Revenue Code. Section 511(a), however, imposes a tax on unrelated business taxable income received by these otherwise exempt organizations.

Historically, the Internal Revenue Service position has been that the marketing of insurance by exempt organizations generally is an unrelated trade or business and, therefore, income derived from selling such insurance is taxable. This position was ultimately upheld by the Supreme Court in United States v. American Bar Endowment, 477 U.S. 105 (1986).

In 1982, two Technical Advice Memoranda (LTR 8302009 and 8302010) (1982 TAMs) were issued regarding farm bureaus that sold insurance. In the 1982 TAMs, regular membership was open only to those who owned or operated farms. Anyone else could join as an associate member. The organizations' activities included lobbying on agricultural issues, distributing of publications, and sponsoring lectures and seminars. The organizations also supported 4-H clubs and provided educational materials to public schools. Associate members paid the same dues as regular members and had similar access to programs and activities, but could not vote or hold office. The 1982 TAMs concluded that the insurance activities were unrelated trade or business, but that dues payments received from both regular and associate members were

not taxable because benefits provided to all members indicated that dues were not clearly attributable to participation in the insurance programs.

Shortly after issuing the 1982 TAMs, the IRS considered associate member dues paid to labor unions and concluded in LTR 8344001 that such associate member dues were taxable. In that situation, associate members were employees outside the collective bargaining unit. They received union bulletins and ancillary benefits from the union's lobbying on workplace matters, but could not vote in any union election or be represented by the union. The union argued that lobbying and other unspecified work-related activities were sufficient to create a nexus between the dues and the exempt functions of the organization. The IRS disagreed.

The IRS took a similar position in then-pending postal union cases. Two of these cases were resolved by United States Courts of Appeal. In American Postal Workers, AFL-CIO v. United States, 925 F.2d 480 (D.C. Cir. 1991), associate members received no benefit other than access to health insurance. In National Association of Postal Supervisors v. United States, 944 F.2d 859 (Fed. Cir. 1991), associate members could attend meetings and serve on committees in an advisory capacity. Educational programs on lobbying, writing and speaking skills were also available to the complete membership. In both cases (Postal Union Cases), dues income from associate members was held to be taxable because access to insurance was found to be the only benefit associate members received in exchange for dues.

As a result of American Bar Endowment and the Postal Union Cases, IRS agents in certain on-going examinations have taken the position that farm bureaus are required to include in unrelated business taxable income the dues received from associate members attributable to the right to purchase insurance.

THE 1994 TECHNICAL ADVICE MEMORANDUM

The National Office of the IRS was asked again to consider farm bureaus and associate member dues in 1994. This resulted in the issuance of the 1994 TAM. The facts of that case were similar to the 1982 TAMs, in that associate members could purchase insurance and had all the rights of regular membership except the right to vote and the right to serve as voting delegates or board members. The IRS viewed the facts as indicating that the farm bureau used the associate member category to boost sales of insurance. The dues income appeared to be a method by which the farm bureau could derive a benefit from its marketing of insurance. Consistent with the development of the case law subsequent to the 1982 TAMs, and in particular, the Postal Union Cases, the 1994 TAM considered (1) whether associate members were bona fide members (that is, whether they

were provided anything of substance other than the right to purchase goods or services from the exempt organization); and (2) whether associate members could or were likely to avail themselves of the exempt functions of the organizations. The 1994 TAM concluded that the associate member class was used for the purpose of marketing access to an unrelated trade or business (i.e., auto insurance) and, as a result, dues from that membership class were taxable to the organization. The organization described in the TAM did not provide evidence of significant exempt activities directed at non-farmers.

IMPACT OF 1994 TAM

A technical advice memorandum is requested by either the taxpayer or by an IRS field office and relates only to the facts of the specific case. As such, it is not precedential in nature. The impact of the 1994 TAM is to treat the associate member dues of the farm bureau in that case as unrelated business taxable income. Farm bureaus with similar facts may be similarly impacted, although the facts and circumstances of each case will have to be considered.

PUBLICATION OF REVENUE PROCEDURE 95-21

In response to questions raised about the 1994 TAM, the IRS, in conjunction with the Office of the Assistant Secretary for Tax Policy, published a revenue procedure. Rev. Proc. 95-21 (copy attached) indicates that the IRS will only treat dues paid by associate members as taxable if the associate member class was formed or otherwise availed of for the principal purpose of selling or providing access to goods or services unrelated to the exempt purposes of the organization.

The impact of the revenue procedure on a particular organization will depend upon the facts of that case. In this regard, the Service will look to the purposes and activities of the organization and not the intentions of its members.

This revenue procedure restates and clarifies the IRS position with respect to this issue and will be helpful in explaining that position to section 501(c)(5) organizations that have established associate member categories.

REVENUE PROCEDURE 95-21

SECTION 1. PURPOSE

The purpose of this revenue procedure is to establish when associate member dues payments received by an organization described in section 501(c)(5) will be treated by the Service as gross income from the conduct of an unrelated trade or business under section 512.

SECTION 2. BACKGROUND

An organization exempt from tax under section 501(a) as an organization described in section 501(c)(5) is subject to the unrelated business income tax imposed by section 511(a). Section 501(c)(5) organizations often receive dues payments not only from members that are accorded full privileges in voting for the directors of the organization but also from associate members that are accorded less than full or no voting privileges. Whether associate member dues payments are treated as gross income from the conduct of an unrelated trade or business under section 512 is determined in accordance with the following section.

SECTION 3. TREATMENT OF ASSOCIATE MEMBER DUES PAYMENTS

The Service will not treat dues payments from associate members as gross income from the conduct of an unrelated trade or business unless, for the relevant period, the associate member category has been formed or availed of for the principal purpose of producing unrelated business income. For purposes of this revenue procedure, unrelated business income is income from the sale of, or

the provision of access to, goods or services produced by an activity which constitutes a trade or business, regularly carried on, and not substantially related to the organization's exempt purposes other than through the production of income. Consequently, other than where the statute or regulations specifically provide a method of allocating a portion of dues payments to unrelated business taxable income, the Service will treat dues payments from associate members as not including gross income from an unrelated trade or business if the associate member category has been formed or availed of for the principal purpose of furthering the organization's exempt purposes.

In applying this revenue procedure, the Service will look to the purposes and activities of the organization rather than of its members.

EFFECTIVE DATE

This revenue procedure is effective for all open years.

DRAFTING INFORMATION

The principal author of this revenue procedure is Charles Barrett of the Exempt Organizations Division of the Office of the Assistant Commissioner (Employee Plans and Exempt Organizations). For further information regarding this revenue procedure contact Mr. Barrett at (202) 622-8152 (not a toll-free number).

Chairman JOHNSON. I am going to submit for the record Mr. Ramstad's opening statement.

[The prepared statement follows:]

Statement of Rep. Jim Ramstad
Oversight Subcommittee of the Ways and Means Committee
Hearing on FY 96 Internal Revenue Service Budget
February 27, 1995

Madam Chair, thank you for calling today's hearing to discuss the budget proposals for the Internal Revenue Service (IRS).

I have strong concerns about the dramatic increase in this year's IRS budget proposal. As Congress seeks ways to dramatically reduce the federal deficit -- with spending control that should affect every government agency -- the IRS has submitted a request for $7.5 billion, a 10 percent increase over last year.

The IRS, which has 113,963 "full time equivalent" employee positions, has remained isolated from the federal workforce reduction President Clinton hails. Even worse, the agency is requesting funding to add 922 full time equivalents.

Perhaps most disturbing, the IRS intends to spend a massive sum on an expensive computer system, which may not be necessary if this Congress succeeds in simplifying the tax code.

Madam Chair, Dr. James Payne, a leading scholar of our tax system, estimates that the "overhead" costs of operating our current system consume around $65 of every $100 in revenue raised. By continuing to build up a massive IRS, it will becoming increasingly difficult to fundamentally reform our existing tax system.

Thank you again, Madam Chair. I am anxious to exploring these critical issues with our witnesses today.

Chairman JOHNSON. Mr. Portman from Ohio.

Mr. PORTMAN. Just very briefly, Madam Chairman. I appreciate your acknowledging me. I had a good meeting with the Commissioner last week. Sorry I was unavoidably detained this morning. I looked over your testimony briefly. I know you addressed the diesel gas and excise tax issue in your testimony. I would ask on the record that we work on that issue with regard to the refunds.

Ms. RICHARDSON. Right.

Mr. PORTMAN. I told you I had some specific evidence the refunds were not being applied back in a timely fashion. I will get that specific information to you.

Second, just on the tax modernization system, I know you have already had an opportunity to talk about TSM. My only question would be whether it might make sense for us to see a list of the top complaints that the Service gets and that we get from our constituents constantly and then match those with the various TSM projects. This would be a project that I would be happy to work with you on. I could provide you with the complaints; you can provide me with the TSM projects that could address them.

Honestly, I think all of us on this panel do get complaints constantly regarding specific matters, and it might be interesting to see where the various TSM projects line up with the complaints and whether they are in fact addressing them, and I would be pleased to work with you on that.

Ms. RICHARDSON. We would like to work with you on that, too, and we will follow up with you.

Mr. PORTMAN. Thank you.

Chairman JOHNSON. Thank you, Mr. Portman.

Ms. RICHARDSON. Thank you, Madam Chair.

Chairman JOHNSON. Thank you, Commissioner.

As the first panel leaves the witness stand, let me call the second panel.

Jennie Stathis, the director of tax policy and administration issues of the GAO; Lynda Willis, associate director; Hazel Edwards, also of the GAO.

As the panel sits down, let me announce that we will have to begin abiding by the 5-minute rule, both panelists and members. We will begin using the lights.

Welcome, Ms. Stathis.

STATEMENT OF JENNIE S. STATHIS, DIRECTOR, TAX POLICY AND ADMINISTRATION ISSUES, U.S. GENERAL ACCOUNTING OFFICE; ACCOMPANIED BY LYNDA WILLIS, ASSOCIATE DIRECTOR, TAX POLICY AND ADMINISTRATION ISSUES; HAZEL E. EDWARDS, DIRECTOR, INFORMATION RESOURCES MANAGEMENT/GENERAL GOVERNMENT ISSUES

Ms. STATHIS. Thank you, Madam Chairman.

Chairman JOHNSON. Please proceed with your testimony and then we will move with questions, and I hope with a little more dispatch than we have to this point today.

Ms. STATHIS. Thank you.

We are pleased to be here this morning to participate in your hearing, and as you have introduced them, on my right is Lynda

Willis and on my left is Hazel Edwards. I will briefly summarize my statement, if I may, and submit it for the record.

First, I will talk a little bit about the tax systems modernization program.

We do believe that modernizing IRS' systems is absolutely critical. The tax processing system was designed in the early sixties. It is outdated. It is paper driven. It is labor intensive. It is hard to get information from it, and when you get it, it is often outdated. So this is absolutely a critical program. TSM is intended to change all of that. It is intended to eliminate the reliance on paper and make information available whenever and wherever it is needed.

IRS has been at this for about 8 years and about $2 billion has been invested, and we believe that marginal improvements have been made as a result of it. That is because the systems that have been brought online so far are ones that automate old processes or they make information available out of old systems. While they improve the current environment, they do not get us much closer to the environment of the future, the ultimate objectives that TSM is intended to provide.

Probably more important to us, Madam Chairman, however, is the next point in our testimony. IRS has devoted a great deal of its efforts to getting prepared to build these new systems, and we believe that over the past year they have made some encouraging progress in these areas, but we remain concerned that these future efforts are still at risk for a number of reasons that we list in the testimony: IRS still lacks sufficient technical skills to implement such a large, complex undertaking as TSM; the development of systems is proceeding at the same time as process improvements are being identified; and, third, there are not good priorities for which systems will give us the biggest bang for the buck, if you will. So, as a result, there are lots of things that are going on at the same time. There are also still not the fully established technical guidelines that are so critical to making sure that each piece of this fits together and works.

Now, the 1996 TSM budget request is for more than $1 billion and it is to fund about 41 projects. Given the lack of sufficient skills to really manage such a large effort, and because there are still problems with getting all of the technical guidelines in place, we are recommending that IRS focus its efforts on the critical few, try to identify the particular projects that will give the greatest benefit in terms of the objective where they want to go in the long run, and to try to focus the resources that they have on bringing those systems online in a short period of time. We think that IRS will get closer to the ultimate TSM objective that way and will get there faster.

The second area is refund fraud, which you have talked about a little bit this morning, and IRS has taken a number of steps this year to deal with refund fraud. Those come after our reports and hearings of this subcommittee. We believe that those actions, if they are implemented effectively, could help reduce the number of fraudulent claims and they could help improve the detection of fraudulent claims.

IRS has delayed at this point about 1.5 million returns of taxpayers. They will delay the refunds of many more before the filing

season is over. Those delays affect taxpayers who claim the earned income credit or who do not use valid Social Security numbers.

We believe that IRS could have done a better job of giving taxpayers adequate advance notice about the earned income credit refunds being delayed, and we think they still need to do a better job of telling people who have invalid Social Security numbers what they have to do to resolve that problem.

We also have some of our recommendations in here that deal with earned income credits, something you asked us to provide because so many of the refund fraud cases involve the earned income credit.

The third area of our testimony is with telephone assistance, which we believe is an important indicator of the service IRS provides during the tax filing season. This year we tested the access over a 2-week period. We made more than 1,000 phone calls, and we reached IRS 156 times.

With that, I will be pleased to answer your questions.

[The prepared statement and attachments follow:]

TESTIMONY OF JENNIE S. STATHIS, DIRECTOR
TAX POLICY AND ADMINISTRATION ISSUES
GENERAL ACCOUNTING OFFICE

Madam Chairman and Members of the Subcommittee:

We are pleased to be here today to participate in the Subcommittee's inquiry into the administration's fiscal year 1996 budget request for the Internal Revenue Service (IRS) and the status of the 1995 filing season.

Our statement addresses four main issues--the status of IRS' Tax Systems Modernization (TSM) program, IRS' efforts to control tax refund fraud, steps that might be taken to make the Earned Income Credit (EIC) easier to administer and less susceptible to fraud, and the ability of taxpayers to reach IRS by telephone. We also have some discussion of other issues related to IRS' budget request. Each issue is discussed in an appendix and summarized below.

BUDGET OVERVIEW

IRS' budget request is for about $8.2 billion and staff of 114,885 full-time equivalents (FTEs), an increase of about $739 million and 922 FTEs over IRS' expected fiscal year 1995 operating level. This overall increase is a net of various increases and decreases, including (1) increases to enable IRS to maintain current operations, (2) several reductions that represent IRS' share of the administration's initiatives to reduce the size and cost of government, and (3) increases to fund program changes.

Of the $521.3 million in requested program changes, $475.6 million is for automation projects, and the bulk of that ($420.7 million) is for projects that IRS considers part of TSM. The other $45.7 million is intended to help IRS deal with the two most predominant filing season issues so far this year and in the recent past--the need to better control refund fraud and the difficulties taxpayers experience in trying to reach IRS by telephone.

TSM

IRS is requesting $1.03 billion in fiscal year 1996 for TSM development, an increase of 66 percent over IRS' proposed operating level for fiscal year 1995. IRS is also requesting $61.2 million for the operation of completed TSM systems.

IRS initiated TSM in 1986 because its tax processing system, the same system still in use today, was outdated and in desperate need of repair. This processing system has remained virtually unchanged since it was automated in the early 1960s. For instance, most of the 200 million returns that IRS receives each year are still submitted in paper form, and only part of the information from these forms is keyed into computers. The processes that IRS employees use are paper-driven and labor-intensive, and employees must contend with taxpayer data that are sometimes difficult to access and that may be outdated and incomplete. Taxpayers, too, are frustrated by often futile attempts to get information when they contact IRS.

TSM is intended to change all this by creating a new tax processing system that virtually eliminates the reliance on paper and that makes taxpayer information available to IRS employees wherever and whenever it is needed. IRS top management has provided a vision of this new workplace and has redefined the organization to be more responsive to taxpayers' needs and mission demands. In addition, IRS is planning to improve key business processes with a goal of achieving dramatic gains in service and productivity. However, after 8 years and an investment of almost $2 billion in TSM systems, IRS has realized only marginal improvements in its operations.

Some initial systems have been completed with TSM funds, but most of these systems simply automate old processes without substantially improving service to taxpayers. We do not dispute

the value such systems could add to the current environment. But we believe that focusing on progress in such systems as part of TSM shifts agency and oversight attention away from the critical path of actions necessary to achieve the ultimate TSM objectives.

IRS made some encouraging progress in the last year in correcting deficiencies in its management and technical infrastructure for TSM. However, we remain concerned that future systems development efforts are still at risk because of a number of factors. These factors include (1) the lack of sufficient technical and management expertise and skills to implement TSM; (2) continued development of systems for TSM without taking into account changes that could occur because of process improvements; and (3) the lack of system development priorities or fully established technical guidelines. Without addressing these factors, IRS risks continuing business as usual, and the opportunity to realize greater service improvements and cost reductions could be lost.

To focus the TSM effort, we believe that IRS should first direct its attention to a small number of projects that address critical gaps in mission performance and are part of the TSM vision. The mission-critical projects include those that would help create a paper-free environment and make taxpayer data uniformly available agencywide. IRS should then devote the full range of its available TSM resources (managerial, technical, financial) to successfully completing these projects within a short period--perhaps 12 to 18 months. By limiting its attention to a few critical projects, IRS could gain control over many of the TSM risks and could begin to move incrementally toward the TSM vision. In light of the need to refocus TSM, IRS may not be in a position, in fiscal year 1996, to effectively use all of the funding it has requested.

These issues are discussed more fully in appendix I.

REFUND FRAUD

As discussed in appendix II, IRS has taken several steps this year in an attempt to better control refund fraud and is asking for additional resources to do more in 1996. This emphasis is in response to serious concerns raised in several GAO reports[1] and congressional hearings and in reports by an IRS consultant and a task force established by the Secretary of the Treasury. These actions, if implemented effectively, could help reduce the number of fraudulent claims being submitted and help improve IRS' chances of detecting fraudulent claims that are submitted.

Some of IRS' new controls are directed at giving IRS more time to ensure the validity of the taxpayer and the claimed refund. As a result, IRS has already delayed the refunds of at least 1.5 million taxpayers and will delay the refunds of many more before the filing season is over. Those delays affect taxpayers who claim the EIC or who do not use valid Social Security Numbers (SSN).

If accounts in the news media are an indication, these delays have caused much confusion and anger among taxpayers and tax return preparers. IRS might have mitigated some confusion and anger if, as discussed in appendix II, it had done a better job of (1) giving taxpayers adequate advance notice of the potential

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[1]Tax Administration: IRS Can Improve Controls over Electronic Filing Fraud (GAO/GGD-93-27, Dec. 30, 1992); Tax Administration: Increased Fraud and Poor Taxpayer Access to IRS Cloud 1993 Filing Season (GAO/GGD-94-65, Dec. 22, 1993); Tax Administration: Electronic Filing Fraud (GAO/T-GGD-94-89, Feb. 10, 1994); and Tax Administration: Continuing Problems Affect Otherwise Successful 1994 Filing Season (GAO/GGD-95-5, Oct. 7, 1994).

delays to EIC-related refunds and (2) telling taxpayers whose refunds were being delayed because of an invalid SSN what they must do to correct the situation and get their refunds.

IRS is asking for an increase of $28.3 million and 323 FTEs in fiscal year 1996 to combat refund fraud. An IRS official told us that the additional resources would be targeted toward prevention rather than detection. We agree with such a focus, because it is less costly and more efficient, in our opinion, to stop a fraudulent return from being filed than to identify and deal with the fraud after the return is filed.

Because most of the refund fraud cases IRS identifies involve the EIC, you asked for our views on what could be done to make the EIC easier to administer and less subject to fraud. Refundable credits, like the EIC, pose a challenge for tax administrators. In addition to the concerns about fraud, there are equally important concerns that not all those eligible for the EIC are receiving it.

We have made several recommendations in the past that could help to make the EIC less of a problem for IRS and taxpayers. As discussed more fully in appendix III, those recommendations called for greater clarity in IRS' forms and instructions; eliminating differences between the definition of a qualifying child for EIC purposes and the definition of a dependent for purposes of claiming a dependency exemption; encouraging the advance payment option, whereby persons eligible for the EIC can choose to receive it in advance as part of their paycheck; and moving toward timely computer matching of employer wage information with tax return data.

TELEPHONE ASSISTANCE

An important indicator of filing season performance is how easily taxpayers who have questions or who want to order forms and publications are able to contact an IRS assistor on the telephone. In reports on past filing seasons, we discussed the inaccessibility of IRS' telephone service (i.e., the difficulty taxpayers had in reaching IRS by telephone).[2] To determine whether telephone service was again a problem during the early part of this filing season, we tested the accessibility of (1) the toll-free system that IRS tells taxpayers to call if they have questions about their account, the tax law, or IRS procedures and (2) the toll-free system IRS tells taxpayers to call if they want copies of tax forms and publications.

Results of both tests showed that accessibility is still a problem. Of the 1,166 calls we placed to the toll-free assistance number, we reached an IRS assistor 156 times--a 13 percent accessibility rate. We were more successful accessing IRS' forms ordering system, but even then we were able to reach an IRS assistor only 47 percent of the time. Our testing methodology and results are discussed in more detail in appendix IV.

IRS is asking for $17.4 million and 239 FTEs in fiscal year 1996 to help it answer 1.3 million more telephone calls. Although these additional resources might help improve accessibility, it will not make an appreciable difference in the large and growing gap between the number of calls coming into IRS and the number it answers. We believe that more taxpayers could get through to an assistor if IRS adopted some of the basic management practices used by other organizations that operate large telephone assistance programs. This is also discussed in more detail in appendix IV.

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[2]See, for example, GAO/GGD-94-65 and GAO/GGD-95-5.

OTHER BUDGET ISSUES

In appendix V, we discuss three other issues related to IRS' fiscal year 1996 budget request:

-- IRS' operating plan for 1995 and its budget for 1996 both assume the receipt of at least $92 million from new installment agreement user fees in both years. To the extent the user fees do not generate the expected revenues, activities included in IRS' appropriation for processing returns and assisting taxpayers will be underfunded.

-- A proposed change in legislative language restricting the use of money appropriated for tax law enforcement could have an adverse impact on IRS' continued implementation of its fiscal year 1995 compliance initiatives.

-- If the federal employee pay raise for 1996, including locality pay, exceeds the budgeted 2.4 percent, IRS will have a funding shortfall in fiscal year 1996--just as it has in fiscal year 1995.

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That concludes my summary statement. We welcome any questions that you may have.

TAX SYSTEMS MODERNIZATION

IRS first articulated its plans for modernization in the mid-1980s and laid out a more specific vision in the early 1990s. IRS' vision calls for a work environment that is paper-free and where taxpayer information is readily available to IRS employees wherever and whenever it is needed. The focus of any TSM systems investment, then, should be on delivering the capabilities of this vision, such as paperless processing, rapid update of taxpayer accounts, and instant access to taxpayer data when responding to taxpayer inquiries.

IRS is funding 41 projects in fiscal year 1996 under the auspices of TSM. Thus, TSM has grown to more than double the 18 projects funded in fiscal year 1993. It is reasonable to expect that any project funded under TSM would be focused on providing essential TSM capabilities. Instead, some projects funded under TSM have focused on the current systems environment.

The systems that IRS has delivered to date under TSM, including the Electronic Filing System, the Automated Underreporter System, the Integrated Collection System, and Corporate Files On-Line (CFOL), have marginally improved IRS' current tax processing and compliance operations. However, they were not built to be an integrated part of the comprehensive TSM program and they have not delivered the large increases in capability and customer service that IRS hopes to have in the future.

For example, CFOL, which provides on-line access to taxpayer account information in the existing IRS master files, brings some marginal benefits to IRS. It speeds return processing by permitting electronic verification of taxpayers' names and addresses, and it gives telephone assistors access to taxpayer account information to help answer questions. However, CFOL's information comes from master files only and does not reflect taxpayer data that may be in other systems, such as the collection and examination systems. Thus, a telephone assistor may not have all relevant and current information when answering a taxpayer's questions. A future TSM module is to provide on-line access to complete taxpayer information.

The fiscal year 1996 budget request for TSM includes other systems that will enhance the current environment but not be an integral part of the future TSM program. These systems include the Examination Automated System, which automates the field examination processes; the Integrated Collection System, which automates the field collection process; the Corporate Systems Modernization and Transition, which replaces and upgrades the Martinsburg and Detroit mainframe computer systems; and the Service Center Recognition/Image Processing System, which replaces the current optical character recognition of simple tax returns and documents. The examples cited account for $156 million, or about 15 percent of the 1996 request for TSM development.

We believe that these systems should not be funded as part of TSM. We do not dispute the value these systems could add to the current environment, but as part of TSM, they shift agency and oversight attention away from the critical path of actions necessary to achieve the ultimate TSM objectives. Specifically, progress in the stand-alone, current-environment systems is not a barometer of progress in activities essential to achieving the TSM objectives.

TSM COSTS ARE UNCERTAIN

IRS has been unable to provide us and the Congress with reliable estimates of what the overall cost of TSM will be. As of October 1992, IRS was estimating that TSM would require about $8.9 billion for systems development and a total of $23 billion

through 2008 for acquisition, operation, and maintenance. IRS' current estimate of TSM costs, as of February 1994, is $9.4 billion for acquisition and $22.3 billion in total. However, we had some concerns with the cost model that IRS used to develop the 1992 estimates and expressed these concerns to IRS in 1993. IRS' cost model has not been updated to address our concerns or changes in the TSM vision and scope. IRS intends to have a new cost model and revised estimates by September 1995. In the meantime, we continue to use IRS' estimates as an indication of the investment commitment that TSM entails. We would note, however, that all of these estimates include the variety of projects discussed above and many of them do not contribute to the central TSM vision.

TSM RISKS REMAIN HIGH

In the last year, IRS has made some progress in its management and planning of TSM. However, unmanaged risks continue to reduce IRS' chances for long-term success. These risks include

-- IRS' lack of sufficient technical and management expertise and skills to implement TSM;

-- the continued development of systems for TSM without taking into account changes that could occur because of process improvements; and

-- IRS' lack of system development priorities or fully established technical guidelines.

Because of these and other risks, we have placed TSM on our list of high-risk government programs.

In May 1994, we issued a report that identified a number of practices that leading private and public organizations used to manage their information resources more strategically in order to improve performance and better meet customer needs.[3] These practices included measuring the performance of key processes; focusing on process improvement; managing information systems projects as investments; and integrating the planning, budgeting, and evaluation processes. IRS has begun to study how it can use these practices to better manage its information resources and gain greater performance and service improvements.

However, IRS' current approach to TSM contrasts sharply with these practices. For instance, the successful organizations made sure that they had skilled and experienced technicians and managers to guide systems development efforts. According to the National Research Council (NRC), IRS needs to attract new skills to transform its software development staff from one of maintaining antiquated current systems to one that can design and build the modern, integrated systems that TSM requires.[4] The NRC also noted that IRS needs to manage its contractors more aggressively to ensure timely production of high-quality software. In this regard, the NRC advised IRS to hire people experienced in managing software development contractors.

Successful organizations also analyzed their business processes and determined how they could be improved before undertaking related automation projects. IRS has taken an important step in

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[3]Executive Guide: Improving Mission Performance Through Strategic Information Management and Technology (GAO/AIMD-94-115, May 1994).

[4]Continued Review of the Tax Systems Modernization of the Internal Revenue Service (Interim Report), Computer Science and Telecommunications Board, National Research Council. National Academy Press, Washington, D.C., 1994.

this regard by initiating process improvement studies to streamline the tax return processing and customer service functions. However, IRS does not know how the results of these projects will be incorporated into the ongoing systems development efforts for these areas. As a result, IRS could end up with systems that do not meet the requirements of the streamlined or redesigned processes. In such a case, systems that have been developed may have to be retrofitted or scrapped.

Successful organizations prioritized their development projects using an explicit set of criteria that assess the mission benefits, risks, and costs of each project. IRS has not set priorities for any of its development projects, instead it considers all projects to be equally important. Priorities are essential for allocating scarce resources, as well as to establish program and project contingencies. The NRC noted in its report that IRS was unable to respond quickly and effectively to the reduction in TSM funding for fiscal year 1995 because it lacked contingency plans.

Finally, successful organizations ensured that they had a technical framework of standards and guidelines in areas such as data management, telecommunications, and security, that enable project teams to build systems that connect together, operate smoothly, and exchange information. Guidelines are also important because systems developed without guidelines may have to be changed or redesigned later, usually at a higher cost. In the last year, IRS has described its technical approach to integrating its information systems and revised guidance to its TSM system developers that further defines the technical and functional design of TSM. For successful integration of all of the TSM systems, IRS must now establish management controls to ensure that all projects use these guidelines.

One long-standing critical gap in IRS' technical guidelines is security. Technical guidelines for security are particularly important because the TSM environment of on-line access will make taxpayer data even more susceptible to unauthorized access and disclosure. Last year, IRS received a draft security architecture from its Integration Support Contractor, but decided not to accept it and began an effort to develop its own security guidelines. To date, IRS has issued a security policy and a draft of high-level security requirements. IRS has also engaged another contractor to perform a data sensitivity analysis and identify which data elements should be given specific levels of security. IRS expects to issue initial security guidance to TSM project teams by April 1995.

The challenges of completing a complex modernization involving large integrated systems are great, and it is easy to lose sight of the ultimate goal. Therefore, it is important that IRS focus management attention and resources on those opportunities that can best improve mission performance. By working on a wide variety of TSM projects simultaneously, IRS has not had such a focus. As a result, while IRS has invested significant funds in modernization, it is still far from its vision for TSM.

REFUND FRAUD

Over the past few years, more attention has been focused on refund fraud. Fraudulent refund schemes are generally based on false claims of federal income tax withheld or refundable credits, such as the Earned Income Credit (EIC) or the Fuel Tax Credit. Perpetrators of schemes include individuals who make false claims using their true names and Social Security Numbers (SSN) and individuals who make false claims using (1) the names and SSNs of unsuspecting, legitimate taxpayers or (2) fictitious names and SSNs.

Although fraud affects all types of returns, much of the attention has been on electronic filing because the speed with which those returns are processed has made it more difficult for IRS to detect the fraud before the refund is issued. Also, although only about 12 percent of all individual income tax returns were filed electronically in 1994, about 43 percent of the returns IRS identified as fraudulent that year were filed electronically.

Table II.1 shows the growth in identified fraudulent returns and refunds since 1990. From 1990 through 1994, as indicated by the information in the table, $102.6 million in identified fraudulent refunds were issued before IRS could stop them. Of that total, $78.7 million (77 percent) related to electronic returns.

Table II.1: Number of Detected Fraudulent Returns and Deleted[a] Fraudulent Refunds in Calendar Years 1990 Through 1994

Dollars in millions

	Paper			Electronic			Totals[c]		
Year	Returns	Refunds claimed	Refunds deleted	Returns	Refunds claimed	Refunds deleted	Returns	Refunds claimed	Refunds deleted
1990	5,302	$15.9	$14.8	411	$1.2	$0.5	5,713	$17.1	$15.3
1991	5,422	32.3	30.7	5,746	10.7	2.6	11,168	42.9	33.3
1992	12,244	33.2	30.9	12,725	33.6	22.5	24,969	66.8	53.4
1993	51,883	82.8	73.0	25,957	54.0	29.1	77,840	136.8	102.1
1994	44,137	90.7[b]	81.5	33,644	69.8	35.9	77,781	160.5	117.4

[a]A deleted fraudulent refund is one that IRS has detected and stopped before the refund is paid out.

[b]This figure excludes two returns claiming refunds totalling $347 million.

[c]Totals may not add due to rounding.

Source: IRS data.

Although the number of identified fraudulent returns is less than 1 percent of the total number of individual income tax returns filed in any year, we have been concerned about the growth in identified fraud and the uncertainty as to how much fraud is not being identified. Accordingly, we have made several recommendations directed at improving IRS' controls, some of which IRS has implemented, and have included filing fraud on our list of high risk government programs. Because the Subcommittee shared our concern, the Secretary of the Treasury established the Task Force on Tax Refund Fraud. On October 6, 1994, the Task Force testified before the Subcommittee and presented numerous recommendations of its own.

IRS HAS TAKEN STEPS IN 1995 TO DEAL WITH REFUND FRAUD

IRS has taken several steps in an attempt to reduce refund fraud in 1995. For example:

-- To better protect against unscrupulous tax return preparers or transmitters participating in the electronic filing program, IRS now requires new program applicants to provide fingerprints, that can be used to conduct criminal history checks, and to submit to a credit check.[5] It is our understanding that IRS plans to decide, after this filing season, whether to extend this requirement to preparers and transmitters who are already in the program. Implementation of this requirement is consistent with a recommendation we made in 1992 that IRS check the background of electronic filing applicants.

-- To better ensure the appropriateness of refund claims, IRS has said that substantial efforts would be directed toward identifying claims with missing SSNs, invalid SSNs (ones that do not match Social Security records), and/or SSNs that were already used by another taxpayer. IRS has added controls that prevent returns with one or more of those conditions from being filed electronically. If a return with one of these conditions is filed on paper, IRS has said that it will delay any refund until the matter is resolved.

-- According to IRS, most of the refund fraud cases it has detected in the past involved the EIC. With that in mind, IRS is delaying refunds on many returns claiming the EIC to allow time to better assure their validity. This action is being taken on returns determined to be most problematical based on an IRS study last year. Because the delay only applies to that part of the refund attributable to the EIC, some taxpayers may receive two refund checks--one for the nonEIC part of their refund and a second, several weeks later, for the rest, assuming IRS determines that the EIC claim is valid. The notice IRS is sending filers to advise them of the delay says that the refund "may be sent to you within eight weeks". IRS has estimated that about 7 million filers will receive such a notice in 1995.

-- Recognizing that the ability of electronic filers to obtain quick loans in the amount of their refunds (known as refund anticipation loans) might increase the incentive to submit fraudulent electronic returns, IRS took steps to disassociate itself from those loans by no longer providing the direct deposit indicator. The indicator, which signaled that IRS would not be reducing the taxpayer's refund to pay another federal debt of the taxpayer, was being used by financial institutions as a basis for making the loans.

These changes, if implemented effectively, could help reduce the number of fraudulent claims being submitted and help improve IRS' chances of detecting fraudulent claims that are submitted. Over the next several months, we will continue monitoring the implementation of these changes. We have two observations thus far about their potential effect on taxpayers.

First, IRS did not, in our opinion, provide taxpayers with adequate notice of the change involving EIC claims and the resulting delay in EIC refunds. We saw nothing in the Form 1040 tax package or in Publication 17 (Your Federal Income Tax) that explained that refunds involving the EIC could be delayed for

[5]The fingerprint requirement does not apply to Certified Public Accountants, attorneys, and enrolled agents.

several weeks. Both documents told potential electronic filers that "some refunds may be temporarily delayed as a result of compliance reviews" to ensure that the returns are accurate. Taxpayers who did not intend to file electronically--about 85 percent of the filers--were not even told that much. Also, by advising only potential electronic filers of possible "compliance checks", IRS may be giving the impression that electronically-filed returns are more subject to audit--not the kind of message that helps expand the use of electronic filing.

Second, some delayed refunds may not be resolved quickly and could cause additional taxpayer burden. When IRS identifies a return with an invalid primary SSN, it puts a hold on the refund and sends a notice (CP54B) to the taxpayer. That notice does not make it clear that the taxpayer's refund will not be released until the matter is resolved and, except in certain circumstances, does not require the taxpayer to send anything to IRS to help resolve the matter. This could result in additional correspondence with taxpayers and a further delay in issuing their refunds.

When we prepared this testimony, statistics were not available on the number of fraudulent refund returns identified this filing season. However, other indicators could be related to the new fraud control procedures.

-- IRS had received 24 percent fewer individual income tax returns electronically as of February 17, 1995 (6,720,000 compared to 8,872,000 during that same period in 1994).[6]

-- About 1.5 million taxpayers had been sent notices as of February 17, 1995, advising them that their refunds had been delayed as a result of IRS' fraud-related procedures.

-- At least 3 million reject notices sent out from the electronic filing system as of February 20, 1995, were for conditions that might indicate a questionable refund. Most of the notices related to some problem with the name and/or SSN of the taxpayer or a dependent. Because a return can be rejected for more than one reason, the number of reject notices may be greater than the number of returns rejected. We do not know how many returns were rejected nor how many of the rejected returns were corrected, resubmitted over the electronic filing system, and accepted.

Before the filing season began, many of IRS' 10 service centers expressed some concern about the impact of delayed refunds on their workloads. The only evidence of increased workloads we have seen to date is a 64 percent growth in the workload of the service centers' Error Resolution Units as of February 10, 1995, compared to last year. We do not know how much of the increase is due to IRS' new fraud procedures or whether that workload has become unmanageable. We will be following up on this issue during our continued monitoring of the filing season.

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[6]Some of the decrease in electronic filings has been offset by an increase in returns filed on paper and an increase in returns filed over the telephone as part of IRS' TeleFile program. In total, however, the number of individual income tax returns filed as of February 17 has declined, from 29,203,000 in 1994 to 28,019,000 this year.

IRS' BUDGET REQUEST FOR 1996 INCLUDES ADDITIONAL RESOURCES TO FIGHT REFUND FRAUD

The administration's fiscal year 1996 budget request for IRS asks for 323 FTEs and about $28.3 million for a "cross-functional effort to combat tax refund fraud". IRS says that the additional resources will be used, among other things, to help it (1) detect and stop fraudulent refunds, (2) identify and refer for examination those EIC cases with audit potential, (3) handle the rapidly increasing inquiry calls associated with these cases, and (4) investigate and prosecute the most egregious cases.

IRS said in its budget estimates that, based on the results of past years' refund fraud efforts, the level of resources being requested should enable it to detect fraudulent refund claims amounting to $474.3 million in fiscal year 1996. That estimate is significantly overstated. Using the average results per staff year that IRS achieved in 1993 and 1994, the expected results in 1996 would be about $210.6 million.

However, an official in IRS' criminal investigations function told us that the ideal result would be for the amount of detected fraudulent refund claims to go down. He said that IRS hopes to achieve that goal by targeting additional resources on prevention rather than detection. We agree with that focus because it is less costly and more efficient, in our opinion, to stop a fraudulent return from being filed than it is to identify and deal with the fraud after the return is filed.

EIC CONTINUES TO CAUSE PROBLEMS FOR IRS AND TAXPAYERS

Even excluding the problems with fraud discussed in appendix II, the EIC continues to be a source of many taxpayer errors and additional IRS work.

In 1994, 14.8 million families received over $15 billion in EIC benefits--an increase over the 14.1 million who received $13 billion in 1993. IRS expects that about 6 million more persons will be eligible to receive the credit in 1995 due to provisions in the Omnibus Budget Reconciliation Act of 1993. Individuals without a qualifying child are now eligible for the credit if they (1) are at least 25 but less than 65 years old, (2) are not a dependent of another taxpayer, and (3) have earned income and adjusted gross income of $9,000 or less.

This expansion has created additional work for IRS. During the processing of returns, IRS' computer system identifies taxpayers without qualifying children who appear to be eligible for the EIC but did not claim it. IRS suspends processing of those returns until they can be reviewed by a tax examiner. If an examiner determines from information on the return and by researching Social Security data (to determine the taxpayer's age) that the taxpayer is eligible for the EIC, IRS will calculate the amount and correct the taxpayer's return.

IRS told us that about one-half of the taxpayers whose returns had been suspended in the first few weeks of this filing season were determined to be entitled to the EIC. According to IRS data as of February 10, 1995, failure to claim the EIC has been the most frequent error made by taxpayers and preparers on this year's returns. The second most frequent error involves mistakes in calculating the EIC when it is claimed.

WHAT COULD BE DONE TO MAKE THE EIC LESS OF A PROBLEM?

Refundable credits, like the EIC, pose a challenge for tax administrators. In addition to the concerns about fraud, there are equally important concerns that not all those eligible for the EIC are receiving it. We have made several recommendations in the past that could help to make the EIC less of a problem for IRS and taxpayers.

In September 1993, we recommended that IRS take certain steps that we thought would make the EIC easier to administer[7]. Specifically, we recommended that IRS (1) modify the Forms 1040 and 1040A to collect the data now required by Schedule EIC, thus eliminating the need for taxpayers to complete and IRS to process a separate schedule, and (2) clarify taxpayer instructions on the need to provide complete information for determining EIC eligibility. IRS continues to require the Schedule EIC but has simplified it by moving EIC computations to a worksheet. IRS' Schedule EIC instructions, in our opinion, are still not clear.

IRS objected to modifying the Forms 1040 and 1040A and eliminating the Schedule EIC. It believed that such a change would confuse taxpayers because of differences between the definition of a qualifying child for purposes of claiming the EIC and the definition of a dependent for purposes of claiming a dependency exemption. A key difference in the two definitions is the requirement, for purposes of claiming a dependency exemption, that the taxpayer provide over 50 percent of a dependent's support (referred to as the "support test"). There is no support test in the definition of a qualifying child for EIC purposes.

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[7]Tax Policy: Earned Income Tax Credit: Design and Administration Could Be Improved (GAO/GGD-93-145, Sept. 24, 1993).

We addressed this problem in a March 1993 report, in which we analyzed four alternatives to simplify the laws on dependent exemptions, including two that would change the support test.[8] On the basis of our analysis, we recommended that Congress consider enacting legislation that would substitute a residency test similar to that used in the EIC program for the dependent support test when the dependent lives with the taxpayer.

Persons eligible to receive the EIC can choose to receive it in a lump sum payment after filing a tax return or in advance as part of their paycheck. In February 1992, we reported that less than 1 percent of EIC recipients in 1989 took advantage of that second option.[9] Although use of the advance payment option would help taxpayers benefit from the credit sooner, it could also create problems for IRS if persons receiving the advance payment later filed a tax return but did not report that they had received the credit in advance. Under IRS' returns processing procedures in place at the time we did our review, those persons could receive the credit again as a lump sum payment. We recommended that IRS take various steps to (1) better ensure that eligible taxpayers are aware of the advance payment option and (2) prevent those who take advantage of that option from receiving the credit a second time. When last we checked, IRS had taken steps to better publicize the availability of the advance payment option but had not revised its procedures to protect against duplicate payment of the EIC.

With respect to fraud on electronically filed returns, we recommended in December 1992 that IRS work toward electronically matching employer wage information with electronic return data[10]. That kind of match is currently beyond IRS' capabilities. Currently, employer wage information other than that provided by taxpayers is not available to IRS until after it has processed taxpayers' returns. This is because of the time it takes to verify the information and correct any errors.[11] IRS has begun to test the possibility of getting partial year's wage information from the states and using that to verify that the taxpayer is employed and to have some information on the taxpayer's amount of earned income.

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[8]Tax Administration: Erroneous Dependent and Filing Status Claims (GAO/GGD-93-60, Mar. 19, 1993).

[9]Earned Income Tax Credit: Advance Payment Option Is Not Widely Known or Understood by the Public (GAO/GGD-92-26, Feb. 19, 1992).

[10]Tax Administration: IRS Can Improve Controls Over Electronic Filing Fraud (GAO/GGD-93-27, Dec. 30, 1992).

[11]Under the Electronic Management System--one of many planned components of TSM--IRS expects to electronically receive tax returns, tax information documents (like W-2s), and correspondence. Electronic transmission of W-2s would enable IRS to more quickly verify and correct the information, thus offering the possibility of having that information available to match with data being reported on electronic returns.

TELEPHONE ACCESSIBILITY

An important indicator of filing season performance is how easily taxpayers who have questions or who want to order forms and publications are able to contact an IRS assistor on the telephone. In reports on past filing seasons, we discussed the difficulty taxpayers had in reaching IRS by telephone (i.e., "accessibility").[12] Although IRS answers millions of calls each year, even more calls go unanswered. Many taxpayers receive busy signals, face long on-hold times, or simply give up.

To determine whether accessibility was a problem during the early part of this filing season, we conducted two tests. One test was to determine the accessibility of the toll-free assistance for taxpayers who have questions about their account, the tax law, or IRS procedures. The second test was to determine the accessibility of the toll-free system that IRS tells taxpayers to call if they want copies of tax forms and publications. Results of both tests indicated that again this year taxpayers are having problems reaching IRS by telephone. We plan to repeat both tests later in the filing season.

To conduct the tests, we placed calls at various times during each work day from January 30 through February 10, 1995. We made our calls from seven metropolitan areas--Atlanta; Chicago; Cincinnati; Kansas City; New York; San Francisco; and Washington, DC. If we received a busy signal, we hung up, waited 1 minute, and then redialed. If after four redials (five calls in total) we had not reached IRS, we considered the attempt unsuccessful. If we reached IRS but were put on hold for more than 7 minutes, we abandoned the call.

DIFFICULTIES ENCOUNTERED IN TRYING TO ACCESS TOLL-FREE TELEPHONE ASSISTANCE

In all, we made 344 attempts to contact IRS' toll-free telephone assistance this year. We succeeded in reaching IRS on the first try 79 times. In 20 cases, however, we abandoned the call after being on hold for more than 7 minutes. Thus, in only 59 (17 percent) of the 344 attempts were we successful in reaching an IRS assistor on the first try. In another 97 cases (28 percent), we successfully reached an assistor after one to four redials--an overall success rate of 45 percent. Our 344 attempts to reach an assistor required a total of 1,166 calls. Of those 1,166 calls, we reached an assistor 156 times--a 13-percent accessibility rate. IRS' own data show a nationwide accessibility rate of 12 percent during the same 2-week period.

In conducting our test, we did not ask questions of the assistors because it was not our intent to assess the accuracy of their assistance. IRS does its own test of accuracy, and we have assured ourselves in the past about the reliability of IRS' methodology. IRS' test data for 1995 showed an accuracy rate of about 86 percent as of February 11. That compares to a rate of about 89 percent for the same period in both 1994 and 1993.

LESS DIFFICULTY ENCOUNTERED IN TRYING TO ACCESS TOLL-FREE FORM ORDERING SYSTEM, BUT ACCESSIBILITY STILL LOW

One way taxpayers can obtain tax forms and publications is to place an order through IRS' telephone form ordering system. The order will then be filled by one of IRS' three forms distribution centers. As with the first test, our intent was to determine how easy it is to reach IRS over the telephone. We did not order any materials. We followed the same redialing and on-hold procedures as described in the toll-free telephone assistance test.

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[12]See, for example, GAO/GGD-94-65 and GAO/GGD-95-5.

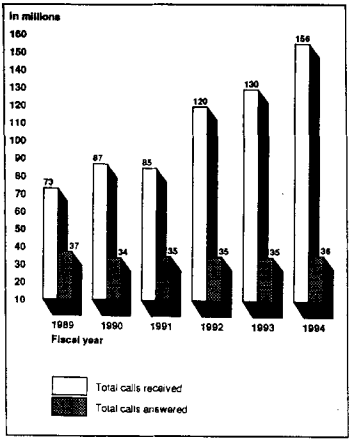
Of 240 attempts to contact the distribution centers, 137 (57 percent) were successful on the first try and 81 (34 percent) were successful after one to four redials--an overall success rate of 91 percent. Our 240 attempts to contact the distribution centers required a total of 465 calls. Of those 465 calls, we succeeded in reaching an IRS representative 218 times--a 47-percent accessibility rate.

We did not assess how well the distribution centers filled orders for tax forms and publications or whether IRS walk-in sites were adequately stocking these materials because (1) our checks in recent years showed that IRS was doing a good job in those areas, (2) IRS contracts for its own test of distribution center performance, and (3) our prior review of the contractor's methodology resulted in changes that have improved its reliability. The contractor's results as of January 27, 1995, showed that the distribution centers filled 96 percent of the test orders correctly.

IRS' REQUEST FOR ADDITIONAL RESOURCES TO IMPROVE TELEPHONE SERVICE WILL NOT APPRECIABLY INCREASE ACCESSIBILITY

The administration's fiscal year 1996 budget request includes an increase of 239 FTEs and $17.4 million to enable IRS to answer 1.3 million additional telephone calls for assistance. Although the increase, if approved, will help, it will not make an appreciable difference in the large and growing gap between the number of calls coming into IRS (which we refer to as "received") and the number it answers, as shown in figure IV.1.

Figure IV.1: Comparison of Total Calls Received and Total Calls Answered for Fiscal Years 1989 Through 1994



Source: IRS data.

We believe that more taxpayers could get through to an assistor if IRS adopted some of the management practices used by other organizations that operate large telephone assistance programs. To maximize the number of calls answered, the four private companies we contacted and the Social Security Administration commonly established (1) challenging program goals for answering as many calls as possible based on customers' needs; (2)

standards for the number of hours employees were expected to be on the telephones and the number of calls answered; (3) standard hours of operation, often extending beyond a 9-hour work day; (4) nationwide standards and uniform ways to measure operations and performance; and (5) nationwide call routing and easy access to customer information.

IRS has not used many of the management practices commonly used by the organizations we contacted. And, in cases where IRS did use a practice similar to those in the other organizations, it was not applied with the same emphasis on customers' needs. For example, IRS has had specific goals for answering more calls for the past 2 years, but these goals are based on the resources IRS has available, not on taxpayers' demand for service. IRS officials believe the gap in the number of calls they are able to answer compared to the number of calls made by taxpayers is so great that it would be unrealistic for them to establish goals based on taxpayer demand.

IRS has, for the first time, provided access to its telephone assistors for 10 hours per work day during the 1995 filing season. This may allow more taxpayers to reach IRS, although there has been no increase in the number of assistors available. IRS has also been working to improve customer service by overcoming the lack of nationwide access to taxpayers' account information. This has been a major barrier to routing calls among IRS call sites. Specifically, in February 1995, IRS provided its assistors the ability to access taxpayers' accounts no matter where the taxpayers filed their returns. Thus, IRS can now route calls to any call site and an assistor will be able to retrieve any taxpayer's account, which should increase taxpayers' chances of being served. These are all positive steps, but it is too early to assess their impact on answering more calls.

Despite the progress made, IRS lacks the capability to centrally monitor and route nationwide call traffic on a real-time basis to available assistors anywhere in the country. IRS also still lacks some basic management practices for its telephone assistance program, including standards for the number of hours assistors should be on the telephone and for measuring performance. We believe that implementing these practices would, over time, allow IRS to answer more taxpayer calls with its existing level of resources, but it is unlikely that IRS would be able to answer all of the calls it receives.

OTHER ISSUES RELATED TO IRS' FISCAL YEAR 1996 BUDGET REQUEST

Beyond those issues discussed already, the most significant questions surrounding the fiscal year 1996 budget request are (1) will IRS receive the expected amount of installment agreement user fees? (2) will IRS successfully implement the fiscal year 1995 compliance initiatives? and (3) is the budgeted increase for a federal employee pay raise sufficient?

WILL IRS RECEIVE THE EXPECTED AMOUNT OF INSTALLMENT AGREEMENT USER FEES?

IRS' operating plan for fiscal year 1995 and its budget for fiscal year 1996 both assume the receipt of $92 million from new installment agreement user fees. Installment agreements allow taxpayers to pay their tax liabilities on an agreed-upon schedule with IRS.

IRS' fiscal year 1995 budget request proposed two new user fees--one for providing a direct deposit indicator associated with the electronic filing program and another for setting up installment agreements. The proposed direct deposit indicator fee became moot when the Department of the Treasury announced in October 1994 that it would no longer provide that indicator. IRS expects to start charging for installment agreements in early to mid-March 1995. The fee is to be $43 for each new installment agreement and $24 for restructured agreements.

In our report on IRS' fiscal year 1995 budget request, we said that it is impossible to predict how taxpayers will react to a fee for installment agreements.[13] For example, some taxpayers may be encouraged to pay their entire tax liability to forego incurring the fee. Others may be discouraged from entering into these agreements because of their cost. According to IRS officials, the $92 million estimate is based on an assumption that IRS will receive about 2 million new installment agreements and 90,000 restructured agreements.

IRS' fiscal year 1995 appropriation act (P.L. 103-329) provided that the Secretary of the Treasury could spend user fee receipts to supplement appropriations made to IRS. Accordingly, IRS' fiscal year 1995 appropriation and fiscal year 1996 budget reflect lower amounts for tax return processing and taxpayer assistance than would have otherwise been the case if there were no user fee provision. If the demand for installment agreements falls short of what IRS expects in 1995 and/or 1996, activities that are included in IRS' appropriation for returns processing and taxpayer assistance would be underfunded.

WILL IRS SUCCESSFULLY IMPLEMENT THE FISCAL YEAR 1995 COMPLIANCE INITIATIVES?

In every year but 1 from 1990 through 1994, Congress has funded compliance initiatives to provide IRS with additional staff with the intent of increasing compliance and producing more revenue. Yet, IRS' compliance staffing declined in that period. For fiscal year 1995, Congress provided IRS with $405 million for more compliance initiatives and restricted IRS' ability to use the compliance funds for other purposes. The fiscal year 1995 appropriation act also said that no funds could be transferred from IRS' Tax Law Enforcement appropriation. These restrictions were imposed because IRS had not fully implemented past initiatives and had used initiative funds to cover budget shortfalls in base operations. In recent testimony before the House Appropriations Subcommittee on Treasury, Postal Service, and General Government, we said that these restrictions increased

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[13]Tax Administration: Analysis of IRS' Budget Request for Fiscal Year 1995 (GAO/GGD-94-129, Apr. 20, 1994).

the prospects that IRS would implement the fiscal year 1995 compliance initiatives.

IRS' fiscal year 1996 budget does not include any funding for new initiatives or additional funding for the fiscal year 1995 initiatives. It does, however, show an annualization of the 1995 initiative for an additional 546 FTEs. According to IRS officials, funds that were used for support costs associated with hiring the new employees in fiscal year 1995, but not needed for that purpose in fiscal year 1996, will be used instead to "buy" additional FTEs for 1996.

The fiscal year 1996 budget also requests a change to the restriction that was imposed in the 1995 appropriation act on the use of compliance initiative funds. In lieu of the language that prohibits any transfer of funds from the Tax Law Enforcement appropriation, IRS is proposing language that would allow funds to be transferred if IRS obtains the advance approval of the House and Senate Appropriations Committees. We believe that the restriction imposed in the fiscal year 1995 appropriations act should be retained to better ensure that IRS uses the compliance initiative funds as Congress intended and to protect against erosion of IRS' enforcement base as occurred in prior years.

IS THE BUDGETED INCREASE FOR A FEDERAL EMPLOYEE PAY RAISE SUFFICIENT?

The President's fiscal year 1996 budget provides for a 2.4 percent federal employee pay raise. For IRS that percentage increase equates to $92 million. It is uncertain whether this amount will be sufficient to cover an across-the-board pay increase and locality pay. IRS' fiscal year 1995 budget provided for a 1.6 percent federal pay raise that was not adequate to cover locality pay. As a result, according to IRS budget officials, IRS needed to absorb an additional $50.7 million for locality pay. If Congress authorizes locality pay for fiscal year 1996 to the levels outlined in the Federal Employees Pay Comparability Act, IRS may need to absorb an additional 2.4 percent average pay increase--$92 million more than the amount provided for in the fiscal year 1996 budget.

Chairman JOHNSON. Thank you very much.

On the efforts that the IRS has made to reduce fraud, you do not appear to be in disagreement; that they are right to focus on the validity of the Social Security number.

Ms. STATHIS. That is a very well-placed effort on their part.

Chairman JOHNSON. Appears to be long overdue as well.

Ms. STATHIS. That is correct.

Chairman JOHNSON. If they had notified as part of the packet to taxpayers that this is a very important matter, frankly, what more is the government required to do? What is the complaint against the IRS in this regard?

I don't care how many times you tell your own children, sometimes they do not listen. Taxpayers are going to figure out that they have to get their Social Security number right when taxpayers do not get their refunds and do not get their filing accepted because they do not have the numbers right.

Ms. STATHIS. Mrs. Johnson, we believe that the IRS has done a very good job of informing people that they have to have a correct Social Security number. That is not an issue. But there are many, many people whose earned income credit is going to be held up who have a valid Social Security number. They are going to be held up because they are caught in one of the predictive profiles that comes out of IRS' study of last year. They appear to be problematic, so the refunds are going to be held.

Chairman JOHNSON. But, again, they are going to wait 2 months. Relative to the billions of dollars that people got last year that they should not have gotten, that were fraudulent, is 2 months a real hardship?

Ms. STATHIS. Well, we do not think so.

Chairman JOHNSON. Or are you saying that the predictive screens were too rigorous and, therefore, were imposing a hardship unnecessarily or irresponsibly?

Ms. STATHIS. No, we are not in disagreement with what IRS is doing.

Chairman JOHNSON. OK.

Ms. STATHIS. In terms of the refund fraud cases, in fact, I think they may have to go beyond where they are and we will see how these work this year. But we may have to go to a system, for example, where we encourage people to get the earned income credit on an advanced basis, to get the 60 percent they can get in their paychecks, and have 40 percent left. We may have to go to a process where they do not get that until May, perhaps. That would allow the entire filing season for IRS to examine all of the patterns that they have.

Chairman JOHNSON. I think we are going to have to take a look after this filing season at even the validity of a lump sum reimbursement when this is actually an income expansion and, logically, should be closely connected to the wage reporting. We do not have the computer capability to do that for several years. So in the interim we may want to really change the system.

But you do not think they are too tough in their screens?

Ms. STATHIS. No, we do not.

Chairman JOHNSON. You agree they absolutely have to screen in order do reduce fraud.

Ms. STATHIS. Yes.

Chairman JOHNSON. So the real issue is, is 2 months too long?

Ms. STATHIS. I think the issue is going to be whether even what they are doing is enough.

Chairman JOHNSON. That may be so, but in terms of the current criticism, would you say 2 months is too long?

Ms. STATHIS. No, I think it is probably not long enough.

Chairman JOHNSON. Now, to get back to the phone system briefly, because your evaluation of their accessibility through their phone system and their evaluation of their accessibility from their phone system are very different. On the other hand, in their testimony they point to a number of things that are fairly recent changes on how they manage phone calls.

Have you talked to them recently? How can you explain to me the discrepancy between your two positions?

Ms. STATHIS. What IRS is telling you is that they have an estimating methodology where they try to estimate the number of taxpayers who are calling in rather than the number of phone calls that are made. That estimating methodology has enough guesswork in it that we quit using it.

But I think our estimates on our 2-week phone call pretty much matched their estimates. So I am warming to their number. If you take the five attempts that we made, our number comes up to about a 45-percent success rate on the five calls. If the same taxpayer tries five times to call at least during the 2 weeks we were testing, they would get in maybe 45 percent of the time according to our test, and that is pretty close to the number that they are using.

But in terms of the absolute number of calls, we got through 156 times out of more than 1,000, which is a 13-percent number. We started using——

Chairman JOHNSON. So behind your 13 percent number is, for an individual taxpayer, a 45-percent shot?

Ms. STATHIS. The 45 percent is probably a good indication of what a single taxpayer would experience if they tried as much as 5 times to get in.

Chairman JOHNSON. Well, we certainly are discussing variations in still an unacceptable range.

Ms. STATHIS. The basic point is the same, which is that telephone access is pretty poor.

Chairman JOHNSON. Last, has GAO made any specific recommendations in terms of modernization of phone services that might address this problem?

Ms. STATHIS. I do not think so, not on modernization alone. Let me have Lynda Willis respond.

Ms. WILLIS. Madam Chairman, the recommendations that we have made to IRS focus on how using management practices we found in companies that we looked at that also have significant telephone operations, how those management practices could actually improve IRS' current level of service without the additional increments that would be brought about by modernization of their equipment, et cetera. These practices included such things as standard hours, more expanded hours of phone coverage, and

things that we found companies that depended on the telephone to do their business were routinely implementing right now.

Chairman JOHNSON. Were your calls made before IRS adopted some of these policies, because they reported today that now they have adopted some of these policies for this filing season?

Ms. WILLIS. The calls that we made were made during this filing season. The recommendations that we have made have not been implemented. IRS has expanded its hours this season to 10, as opposed to 24 at the companies that we looked at—on a per day basis. We would expect that based on the improvements IRS has made that accessibility should go up over the entire filing season, and should compare better than last year; but it is still not going to be enough to close the gap.

Chairman JOHNSON. The key thing is using the equipment that they have for more hours than they are currently using it.

Ms. WILLIS. Right, and possibly putting more people on the phone.

Chairman JOHNSON. Last, in terms of the modernization issue, it is difficult from the general description to determine, in a sense, the merit of what you are saying versus the merit of what the IRS is saying. They did give us some very interesting examples of old processes that they have modernized and in the course of modernizing it, not only gotten more taxpayers to pay up but also taxpayers to pay more accurately the amount they owe resulting also in increased collections.

Now, that does matter a lot. Why is that not worth doing?

Ms. EDWARDS. The issue, Madam Chairman, is not that that function is not worth doing; the issue is whether that function represents a part of TSM, which is the objective of providing information on a taxpayer within IRS such that it is the same information, such that it is consistent, such that it is available quickly, and getting rid of paper processes for the broad agency operations within IRS.

When you look at each of those systems, let us go to ICS, which is the integrated collection system, the specific system Mr. Westfall pointed to. The points that he makes are absolutely correct in terms of what that system does in today's environment, in the current environment. However, it is important to understand that that system is an automation of the final process in the collection chain, and the gains that have been identified apply to that very specific component where the revenue officers are engaged.

But the other more significant point about that system is that it is a stand-alone system and does not connect to anything else, which means the information in that system is not available to a tax assister who is answering a question from a taxpayer calling in about their account. The essence of TSM must be to provide uniform information to anyone within the IRS so that they can respond to taxpayers in a way that is reasonable, accurate, and consistent.

I think if there is one thing we have heard, and I am sure you have heard as well from your constituencies, is that there are instances when people call into IRS and they might call on several different occasions.

Mr. JOHNSON of Texas. Madam Chair.

Chairman JOHNSON. Yes, just one moment.

So, in essence, your choice, then, is, given limited resources, that we should dedicate the resources to the TSM goals even at the expense of improving the quality and effectiveness of some of the current systems that are going to be there for a considerable transition period.

Ms. EDWARDS. Actually, Madam Chairman, we are suggesting that for those improvements that need to be made to the current environment, to keep the operations moving along or to make some very essential changes now, that those decisions need to be made on a one-for-one basis; that is to say, if the ICS or integrated collection system is something that is really needed, it needs to stand on its own, not as part of the TSM arena. It should not be presented in that construct because it gives the impression that more is being done for the long term than is actually happening.

So we are suggesting that the IRS focus on those current initiatives that need improvement and for which business decisions would dictate that they make some short-term automation effort, but not justify it in terms of TSM because it is not a contributor to TSM.

In terms of phasing, as we talk about the integrated collection system, it is being perceived in a logical sense as a phasing toward the long term, but, again, that system technically does not fit into the long-term system. So in terms of a technical building block, it is not that.

Chairman JOHNSON. Let me yield to my colleague from Texas, Mr. Johnson.

Mr. JOHNSON of Texas. Thank you, Madam Chairman.

I was interested in the comment you made that this big system we are building is not going to be accessible except right here. Is that true?

Ms. EDWARDS. When I was sharing about the integrated collection system?

Mr. JOHNSON of Texas. Right.

Ms. EDWARDS. I was saying that that system is only available to people in a particular function, so that if it is a taxpayer assister that is at an 800 number, for example——

Mr. JOHNSON of Texas. Right.

Ms. EDWARDS. They would not have access to information which might be——

Mr. JOHNSON of Texas. So they could not help them, in effect.

Ms. EDWARDS. They would help the taxpayer, but if there were significant information in that collection system related to a recent contact, the tax assisters would not have access to that information.

Mr. JOHNSON of Texas. The other question, Madam Chairman, is are there segmented parts of this computer modernization that we are seeing? It is not an integrated system.

Ms. EDWARDS. That is the point we are making with regard to the systems that have been delivered to date.

Now, the objective, the goal as presented by Mr. Westfall earlier, is that ultimately the tax system modernization initiative would be an integrated system. But what we are saying is that based on the

systems that have been delivered to date, those systems, ICS as an example, do not integrate.

Mr. JOHNSON of Texas. Thank you very much. Thank you, Madam Chairman.

Chairman JOHNSON. Ms. Edwards, I am far from a computer expert. I am embarrassed at my ignorance in this area. But in preparation for this hearing I had some discussions with businesspeople and computer people, and we are soon going to be able to link far more cheaply and effectively.

So it seems to me if you improve the collection system down the road apiece, as you improve other parts, you link them all together, and the integrated system comes from linking access to the information. The linking capability that is part of the larger project does not in any way compromise the improvement of the collection system. I do not understand why IRS is not right in saying, look, we fix this and later on as we get down the road and we can link together, we have better stuff to link.

Ms. EDWARDS. The distinction, the disconnect, if you will, is that the system that they are building today, the one that they pointed out specifically, will not—that system, that physical system, will not be able to link, as you say. They will essentially be forced to rewrite the system. To take the idea, but to redevelop the system, will cost additional moneys.

The point that we are making is that while we are aware of that right now, let us collectively figure out how to identify the needs within the business and then to identify the systems that are going to be essential to support those needs——

Chairman JOHNSON. Ms. Edwards, are you saying when they modernize the collections program, presumably, they could have rewritten the program at that time so that it would be a part of the larger system?

Ms. EDWARDS. Yes.

Chairman JOHNSON. Now, did they not do this because they are not far enough along in the planning about the major system?

Ms. EDWARDS. I believe——

Chairman JOHNSON. Did they not do it because they did not have time, because it is a much bigger project than tweaking the system that they have? Why did they not do it?

Ms. EDWARDS. There probably are a host of reasons why the systems were not built that way. The ones that have been delivered, at any rate to date, were not built that way.

Some of those systems originated in the field in functions where users decided they needed to have a capability and they started to build a capability to satisfy a current need. Somewhere along the line those systems were adopted as part of the TSM umbrella. The specifics of how the systems were built or how they were going to link together were not modified. So the TSM became a collection of initiatives, if you will.

Chairman JOHNSON. Thank you. You have been very helpful. Mr. Levin.

Mr. LEVIN. I think this has been useful. One of the frustrating aspects of these hearings is we hear these things seriatim, so there is nobody here who testified before, right?

Chairman JOHNSON. No, there is not. But they are going to be talking together and we will have another round about this.

Mr. LEVIN. Because I am not sure that they would agree with this description. They gave the example of laptop computers. I do not quite see why those cannot be plugged into a new system.

Ms. EDWARDS. The hardware may very well be useful. The point that we are making is about the software, if you will, the engine that is going to help the hardware provide that service. It is the software that must integrate. So it is the software, the systems that have been developed and delivered already, that will have to be rewritten.

Mr. LEVIN. Are you saying it could have now been written so it could have plugged into an ultimate system?

Ms. EDWARDS. That is correct.

Mr. LEVIN. Well, it seems to me it is fairly easy to get some back and forth on that.

Chairman JOHNSON. If you will yield?

Mr. LEVIN. Please.

Chairman JOHNSON. But you yourself said that they have not set the technical standards, that there is a lot of this plan that they have not refined and finalized. So I don't know how they could have programmed to the larger plan when the larger plan is not thoroughly developed.

Ms. EDWARDS. That was the point, Madam Chairman, that we made last year, and we had made the year before as well with regard to the need for IRS to focus on more of the fundamentals, the fundamentals being those factors that would allow IRS to build systems that would tie together, and that a lot of attention needed to be placed there.

Over the past year IRS has made some significant strides in getting those technical standards in place, and they are saying now that April of this year they will be able to give those technical guidelines.

They are essentially rulings of the road; how do we build things, how do we write code, what are the norms, if you will, for building the system. Those guidelines will be available to the project teams in April of this year, in a couple of months.

Mr. LEVIN. So you and I are working on the staple points, and while it seems a bit detailed, it is a really a major issue now.

I do not think, then, you are criticizing their transitional efforts as much as you are saying they were not careful to make sure what they are doing transitionally would plug into the ultimate.

Ms. EDWARDS. That is exactly correct.

Mr. LEVIN. Well, why do you not all converse and let us know? I mean, really, give us—you are all part of the same government, eventually, and one would hope you could get your heads together and work this out. You are not so critical of what they have done transitionally, are you, in terms of the steps they needed to take?

Ms. STATHIS. Mr. Levin, let me say that people who reacted to this took our term "marginal improvement" as being a criticism. We are trying to describe to you the facts as we see them in terms of what has been produced to date. It is not necessarily a criticism, it is just describing to you what has been produced with the systems that have been delivered.

Mr. LEVIN. But the systems that have been produced may well deliver much more than they have so far?

Ms. STATHIS. No, I do not think so. I think——

Mr. LEVIN. So it is a criticism, then?

Ms. STATHIS. We are hoping that the modernized environment that IRS is planning will produce far more benefits than what has been delivered to date.

Mr. LEVIN. Everyone acknowledges that they do. But the question is, whether implicit, built into what they have been doing there, are the potentialities for much more. That is the issue.

Ms. EDWARDS. I think it is——

Mr. LEVIN. Strip away all the kind of fancy language. I mean, I do not know how critical—it is hard to read this, how critical you are and what you are criticizing. Sum up—my time is expiring—what you are criticizing in terms of the TSM. You are criticizing the transitional steps they took or that they failed to be sure that it phases in easily enough into the ultimate product or something else? Sum it up for the people—some people do watch this, and they may not all be like my children, born and raised with computers. What are you criticizing?

Ms. STATHIS. Let me focus it in terms of what we think needs to be done. The fiscal year 1996 budget asked for money to fund 41 projects. It is just a massive number of projects, some of which will give a lot of benefit, some of which may not give much benefit at all. We are saying prioritize those projects. Let us identify the ones that are going to give us the biggest bang for the buck and put our efforts on those.

I think that is our main issue, our main suggestion, for dealing with this modernization at this point. It will get us closer to where we want to be sooner.

Mr. LEVIN. All right. Well, I think that is a somewhat different issue than we have just been talking about. I do not see that those are——

Ms. STATHIS. It is——

Mr. LEVIN. Criticisms seem to run through your pages and it is hard to separate out.

Ms. STATHIS. It is related, Mr. Levin, in this way. If you only have so many people and so many resources to build a system, do you spend more of your time improving the really old system that you have, or do you devote more of your efforts to trying to produce the system of the future? If you continue spending all of your time and resources in improving this antiquated system that you have, you may not get to where you want to be.

Mr. LEVIN. Unless you plug in the transition to the ultimate product.

Ms. EDWARDS. That is true, but, Mr. Levin, I think the point we are making is that the transition to the ultimate product is not clearly defined; that there is discussion about it, but that what is happening and what we are seeing out of the current initiatives being completed is that there are systems being completed that essentially reinforce the current operation without giving those dramatic improvements that IRS speaks of and wants to get.

Mr. LEVIN. My time is up.

Chairman JOHNSON. Thank you.

Mr. Herger.

Mr. HERGER. Thank you very much. Ms. Stathis, I believe during your testimony you mentioned we have been 8 years spending about $2 billion marginal improvement. I believe that over the next 5 years we are projected to spend an additional $6.7 billion in taxpayer dollars, but Internal Revenue is indicating that they feel they will be receiving out of that $6.7 billion, $9.2 million in productivity savings. Could you validate these cost estimates and also validate the productivity savings?

Ms. STATHIS. I think we will have to get back to you on that. The $9 billion that you have, is that productivity savings or is that their estimate of the total benefits?

[The following was subsequently received:]

In January 1995, IRS issued a study in which it presented data on the expected costs and benefits of TSM during the 10-year period from fiscal years 1996 through 2005. That study showed (1) costs of $6.8 billion and benefits of $9.2 billion over the next 5 years and (2) costs of $12.6 billion and benefits of $32.3 billion over the full 10 years. Some of the reported benefits derive from investments that were made before 1996, while some of the costs incurred during the 10-year period will continue to yield benefits beyond 2005. For this reason, the report is not a typical cost-benefit analysis.

Of the $32.3 billion in benefits cited in IRS' report, almost all ($30.9 billion) are expected to come from the increased revenue generated by redeploying staff and enhancing compliance efforts. The rest is to come from interest savings ($1.3 billion) and labor savings (.1 billion). Increased revenues are not the same thing as "productivity savings" or savings of public resources. Tax revenues are simply a transfer of resources from taxpayers to the government. If IRS had wanted to show resource savings, it would have reported the dollar savings associated with the staff reductions made possible by TSM. Instead, IRS reports the additional revenue that can be obtained by reinvesting staff savings into expanded enforcement activities. The report, therefore, is essentially a budget-impact analysis rather than a social cost-benefit analysis.

We did not do the kind of work necessary to validate IRS' estimates. However, IRS has acknowledged that its study represented a preliminary, short-term analysis and that it has certain flaws, such as reliance on an outdated cost model. IRS expects to issue an economic analysis in September 1995 that it says will better reflect the costs and benefits that will be attributable to modernization. For one thing, that analysis is expected to cover the complete 18 year TSM life rather than the 10 years covered by the January 1995 study.

Mr. HERGER. Productivity savings.

Ms. STATHIS. If it is productivity savings only, I cannot speak to that number. As each of these systems has been tested in a particular location, IRS has tried to estimate from that what the productivity savings will be. Generally the IRS budget will reflect the savings that they hope to achieve when those systems are going to be implemented.

Mr. HERGER. I think the numbers that we have are total cost of $6.683 billion and total benefits of $9.166 billion.

Ms. STATHIS. I suspect that comes from a new cost-benefit study that was just made available to us on Thursday of last week. I believe that those benefits include more than productivity savings. I think they include efforts to redeploy resources into new compliance functions and all of the benefits that they think might accrue from that.

Mr. HERGER. In another area, GAO published a report in October 1994 titled, "Continuing Problems Affect Otherwise Successful 1994 Filing Season." On page 25 of that report you have a chart on fraudulent refund claims. A footnote to this chart states, "This figure includes two returns claiming refunds totaling about $300 million."

Would you please elaborate on this footnote and what type of refund claims could result in such significant amounts of $300 million.

Ms. STATHIS. I believe both of those were gas tax refund claims. Those refunds are probably more problematical than the earned income credit in that there is not a limit on them, so you can have really huge claims for refunds.

Mr. HERGER. Could you tell me were these identified by the IRS and were they stopped?

Ms. STATHIS. They were identified by the IRS and I believe they were both stopped.

Mr. HERGER. Do we have any indication of what happened to these individuals who submitted these fraudulent returns?

Ms. STATHIS. I do not have that information, but I can seek it.

Mr. HERGER. We would be very interested—were they brought to trial? Were they convicted?

Ms. STATHIS. I know there have been a number of prosecutions of fraudulent gas tax refund claims.

[The following was subsequently received:]

According to IRS, this is still an active investigation. They were reluctant to provide further details.

Mr. HERGER. Just maybe a quick followup to an earlier question that came up, and it had to do with the telephone calling—whether or not we are 13 percent successful or closer to 50 percent. Is this temporary? Are we correcting it?

Even at 50 percent—even if we move up from 13 percent to, I don't know what you had, 45 percent I believe, I don't believe that is acceptable to anyone who is making calls, paying accountants to make calls, or doing the public taxpayer themselves.

Are there any moves that are being made to move this up to a more acceptable level? Particularly in the testimony I understood from the IRS was that it is a savings to us to be able to conduct

our business over the phone rather than through the mail. Is there something being done on this?

Ms. STATHIS. There are a number of things being done, but I am not very hopeful that this is going to get better very soon. We have a graph in our statement that shows the past several years the number of phone calls coming in and the number that have been answered. The demand of the phone calls coming in continues to go up and the number of phone calls they are able to answer are pretty static. That is why we are recommending in a draft report that we have been talking with IRS about that they have to make some drastic management changes to try to get more out of the resources that they currently have.

The 1.3 million more calls that they say they will be able to answer with the additional funds they are asking for in 1996 I fear will do little. It may allow them to keep up—given that there will be more calls coming in. I just don't think that it will do a lot to improve the record.

Mr. HERGER. Would you concur that it does save us money to be able to handle these questions by phone rather than through the mail?

Ms. STATHIS. Conceptually, I think that that is probably a correct understanding. Assuming that you can resolve the question on the telephone, that should be more efficient than handling correspondence.

Mr. HERGER. I believe you mentioned earlier that they are going from 8 to 10 hours, and the public sector has perhaps 24 hours.

Ms. STATHIS. That is right. Most private companies that have telephone operations offer that service 24 hours a day.

Mr. HERGER. OK. So there is a great more that we could be doing.

Ms. STATHIS. Yes, there is a lot to be done.

Mr. HERGER. Thank you.

Chairman JOHNSON. Mr. Hancock.

Mr. HANCOCK. Thank you, Madam Chairman.

Following up on Mr. Herger's question about the $300 million on two returns, I noticed on a report here that you have the data through June 1994. I am assuming that the data for all of 1994 probably is available now, but just to make a statement, if you analyze that and take the $300 million out and then you add back in another 25 percent, it would appear that there has been very little increase between 1993 and 1994.

Ms. STATHIS. For——

Mr. HANCOCK. For fraudulent returns.

Ms. STATHIS. Of fraudulent returns. I think that is correct. In our statement we have the statistics for the entire year of 1994 and the number of fraudulent returns in 1994 is actually slightly below 1993.

Mr. HANCOCK. OK, fine. Well, I didn't see it. I made analysis of it and that is the way it would calculate.

The question we have here, you know you were talking about the fact that you can't integrate the two systems, but I mean we are putting data into a system that you say can't be integrated, but as long as we have the data in there, that data can be transferred into the system that can be integrated; can it not?

Ms. EDWARDS. I think it is fair to say that the information will be placed in the new system whenever that new system arrives. The data is transferable, but of course it means that it has to be transferred manually very likely.

Mr. HANCOCK. Transferred manually?

Ms. EDWARDS. Yes. I wanted to make the distinction when we say that a system is not integrable. It cannot be integrated. We mean that the information can't flow from one system to the other. I just wanted to clarify that point.

Mr. HANCOCK. Wait a minute. Wait a minute. I am a little confused. I don't know all that much about computers also, Madam Chairman, but the fact is that once the data is in a database it is usually available to pull out electronically and to enter into another form in some manner.

Ms. EDWARDS. You mean electronically.

Mr. HANCOCK. Electronically, yes.

Ms. EDWARDS. That is the notion that is behind integration. When we talk about integration that is what we mean. It means that you should be able to pull the data from the system electronically and electronically pass it to another system.

Mr. HANCOCK. OK.

Ms. EDWARDS. That is why the issue of integration is so crucial to this discussion and what we are saying about these systems that have been developed to date is that those systems do not allow the information to be pulled electronically from one system and passed to another system.

Mr. HANCOCK. Well, let me ask what—maybe it is not a simple question, but have you all talked to the credit card industry? I mean, my goodness, the hundreds of millions of entries that they make daily are probably much bigger than what the Federal Government does, because everybody has got a credit card. If they handle their affairs like we are handling ours, that thing never could have existed. Why can't we take a look at what they are doing, get some of their experts to come in and tell us what we need?

Ms. EDWARDS. Mr. Hancock, the point that you are making is the essence of our suggestion that IRS needs to have the sufficient number of managerial and technical experts, if you will, or people who are skilled in building these systems that link, that integrate, that pass data electronically so——

Mr. HANCOCK. But can they do that in-house? I mean do they have the personnel to do it or do they need to go to the credit card industry and get their people to do it on a contract basis? Give them a figure. Say, look, I wonder what would happen. We are going to spend $9 billion. I wonder what would happen if we would tell the industry we will give you an award of $5 billion if you will do this.

We are not going to give you anything unless you develop a program, but we are going to give you $5 billion if you do it. I bet there would be a lot of computer programmers start trying to figure out how to go about doing it. This guy that took the bank for $1 billion here just recently, I mean that guy could probably figure this thing out.

Thank you, Madam Chairman.

Chairman JOHNSON. I am stunned, Ms. Edwards, by your comment that you can't get the data off of the system electronically. I never heard of a computer system from which you could not take data.

Is that really true that they can't get this data off in order to feed it into another system if they wanted to do that?

Ms. EDWARDS. Let me answer that question by example and maybe this will help to clarify it. IRS tried to integrate some of these systems, the integrated collection system was one of them, and there are several others that I think are highlighted in the Commissioner's and in our testimony.

Their technicians discovered that it was tougher to try to integrate them—to try to make them link up to try to pass the information from one to the other—than to rewrite. So they chose to rewrite. That is the point that we are raising. These systems that have been delivered to date offer value in selected functions, be it collections at the revenue officer's site or be it the identification of underreported income in the AUR application. While they may offer value there or do offer value there, they are not part of a broader, more comprehensive, integrated or linked environment. You can't pass information among them.

Chairman JOHNSON. Are you suggesting that they are going to need to rethink what information they are collecting and what format it is going to be arrayed in this, the new system?

Ms. EDWARDS. That is absolutely part of what they are in the process of doing now and what we are saying they should place even more emphasis on.

Chairman JOHNSON. I can see that. I don't see how they could have improved the collections system in harmony with this larger system since the larger system's criteria are only now being developed.

Ms. EDWARDS. That is true.

Chairman JOHNSON. So it is just a question of you think they shouldn't have spent the money on that when they should have spent the money on some other things.

Ms. EDWARDS. That is correct.

Chairman JOHNSON. Two other things just to get the record clear. First of all, back to the issue of fraud, would you comment on the vulnerability of the tax system in general to fraudulent collection attempts associated with refundable tax credits? In other words, is refundability of tax credits a policy that we should steer clear of because it is hard to implement?

Ms. STATHIS. Refundable credits are a particular problem for a tax administrator. Normally, credits that are applied against a tax liability are deducted from money that is paid in and so you are just returning a portion or evening out, if you will. But a refundable credit entitles the person to money that they wouldn't otherwise be entitled to whether they paid taxes or not. The earned income credit puts IRS in the role of being more of a welfare-benefit agency than a tax administrator. Trying to decide eligibility for that particular benefit is essentially what we are trying to do through the tax system, and that creates a particular vulnerability that isn't there in other parts of the system.

Chairman JOHNSON. It is true that IRS does not at this time have the capability of cross-checking wages and returns?

Ms. STATHIS. There is an experiment this year in one service center in an attempt to use three-quarters of the wage data from one State to see if that, in fact, will work.

Chairman JOHNSON. But it will be several years before they would have the ability to cross-check wage data in a timely fashion to determine refund, correct?

Ms. STATHIS. The so-called up-front matching is one of those benefits that we are hoping to get out of the long-term tax system modernization design.

Chairman JOHNSON. So would it be reasonable to restructure the EITC so that the only benefit available under it was a wage-based refund benefit with no lump sum possibility? Would that eliminate fraud?

Ms. STATHIS. It probably wouldn't eliminate fraud, but it might help. One of the problems——

Chairman JOHNSON. Why would you say it only might help since it only would go back out through the employer and through the earnings system, and it is the earnings system that makes this person eligible for this refund.

Ms. STATHIS. We did a report on the advanced credit as well and it is not without its own concerns, without its own problems. Not the least of which is that a person could work for more than one employer, a person could have other sources of income, so that the eligibility for the credit needs to be determined at the end of the year taking into account all of the earnings and the situation of the employee.

I don't think there is a lot of verification up front that the children really are qualifying children in compliance with the credit provisions. So there are a lot of those eligibility provisions that still have to be taken into account at the end of the year.

At the time we looked at it, there were also no controls in the system that would prevent someone from getting the advanced credit and then after the completion of that year also applying for the full lump sum credit and getting it in addition. So there are some problems with the advanced credit as well.

Chairman JOHNSON. Certainly, it does suggest that we should not pass more refundable credits until we get the problem straightened out with those that we have on the books.

Any recommendations you have in regard to changing the tax law to make it more enforceable in the refundable credits area we would be very interested in, since we will be working in that area in the very near future. Second, we would be interested in any concrete recommendations you might have in terms of improving the phone system and solving the problems of taxpayer access, because I think it is fair to say that all members of the subcommittee believe significant progress needs to be made in that regard and in the near future.

[The following was subsequently received:]

Based on a recently completed review of the accessibility of IRS' toll-free telephone service, we concluded that IRS top management had not exercised its authority to establish and enforce policies necessary to build an effective nationwide telephone assistance program. While acknowledging that more funds would enable IRS to provide more service, we made several recommendations that focused on maximizing service with existing resources.

Specifically, we recommended that the Commissioner of Internal Revenue direct the Chief, Taxpayer Service, in coordination with other appropriate IRS officials, to lead an aggressive effort to (1) identify and define the appropriate telephone assistance program operating practices for IRS that would allow it to optimize the number of calls it can answer and (2) work with the leadership of the National Treasury Employees Union to reach agreement on implementing those practices on a nationwide basis. Those practices should include, although not be limited to, the following:

-- challenging program goals for increasing the number of calls answered that are based, at least in part, on taxpayers' needs;

-- standards for the amount of time assistors should be available to answer taxpayers' calls;

-- hours of operation that offer taxpayers greater opportunity to reach IRS assistors; and

-- uniform reporting definitions for the number of calls answered and other performance measures.

We also recommended that the Commissioner direct the Chief, Taxpayer Service, to take the steps necessary to (1) fully implement the features of IRS' existing call routing technology and (2) pursue opportunities for more effective call routing through IRS' telecommunications vendor.

Let me raise with you one last issue. You have said, or at least implied, that the IRS doesn't actually have the technical capability that they need, the level of experience that they need in planning and implementing this TSM system.

In their testimony, they mentioned that 75 percent of the money goes out for equipment or consultants. It seems to me not only unwise, but probably impossible under our personnel rules to attract the kind of people that you would need to put this kind of plan in transition. Once you get it in place, you can buy sufficient capability to keep it running and to upgrade. But, I am not sure that the criticism, that the Department doesn't have on board the people who could manage a project of these dimensions, is fair when the testimony was that we don't have them on board. We contract to get this expertise and that, indeed, makes more sense. Would you care to comment?

Ms. EDWARDS. Seventy-five percent of the resources being contracted out, I think, refers to 1996 and what they plan to do for 1996. One of the recommendations that had been put forth to IRS last year as part of the appropriations process was that they would focus very seriously on how they used contractor support in order to address this particular issue.

The point that you raise with regard to the likelihood of their being able to attract enough people with the right kind of technical skills, I think, is a very significant point. I would simply offer that even to manage this kind of effort, there is a core of expertise that is required within IRS to effectively manage the contractor support in order to make sure that government gets value for the dollars spent. IRS has hired some people, a few people with more technical expertise in building integrated systems. I emphasize that because IRS does have skill sets in building the stand-alone or stovepipe systems we were talking about earlier, the ones that don't pass information among them. But the integrated system requires a different skill level. Even to manage the development of an integrated system requires a different level of skills. So the point of their expertise is to the management as well as their support of the implementation.

I don't know if the chairman is aware or the subcommittee members are aware, but IRS has somewhere in the vicinity of 2,400 people dedicated to the TSM initiative and there is a range of skills captured by that number. So, yes, there are a lot of people involved with the modernization effort. We are emphasizing the importance of bringing that critical core, if you will, of expertise into place.

Chairman JOHNSON. In your high risk report focusing on accounts receivable of the IRS, you claim their accounts receivable have grown from $87 to $156 billion between 1990 and 1994. The Commissioner indicated that that difference is primarily accounts that will never be receivable, that are either bankrupt or for some other reason are incapable of paying. Would you agree with that?

Ms. STATHIS. IRS pointed to the change from a 6- to 10-year statutory time on collections. We used to adjust those charts to show the difference between the 6- and the 10-year growth to try to level it out, if you will, or to adjust the growth for that. The information is not there to do that very well. Any numbers that IRS has are ballpark estimates. There are some accounts and a fair amount of

the dollar growth attributable to the change in the statute. But I wouldn't say that it is the bulk of the growth.

Chairman JOHNSON. That is interesting. Your report did show that their collection of delinquent taxes has declined in dollar amounts.

Ms. STATHIS. It has slightly declined. It has been relatively flat over a period of years, but actually down a little bit since 1990.

Chairman JOHNSON. We have put new resources into this. We have really focused on it. Why hasn't it gone up?

Ms. STATHIS. Actually, the compliance resources between 1990 and the end of 1994 went down. Even though there have been some proposals to increase the staffing, it really did not increase and that is why the 1995 compliance initiative was important to improving the enforcement posture of the IRS.

Chairman JOHNSON. Thank you. If there are no other questions, thank you very much for your testimony, and we look forward to working with you in the months ahead and thank you for your attention.

We will next have Mr. Buckley, the president and CEO of H&R Block. I would like to call Mr. Martin also to the table and we will hear both witnesses.

Mr. Buckley, if you will start.

STATEMENT OF HARRY W. BUCKLEY, PRESIDENT AND CHIEF EXECUTIVE OFFICER, H&R BLOCK TAX SERVICES, INC.

Mr. BUCKLEY. Madam Chair and members of the subcommittee, my name is Harry Buckley and I am president and chief executive officer of H&R Block Tax Services, Inc. I appreciate the opportunity to appear before you today to present H&R Block's views on the 1995 tax filing season, IRS' efforts to combat refund fraud and reform of the earned income tax credit.

H&R Block is headquartered in Kansas City, Mo., and we are the Nation's largest income tax preparation firm. We serve approximately one out of every seven U.S. taxpayers. We have over 8,000 company-owned and franchised offices throughout the United States and employ over 89,000 people during the tax filing season.

Last year, we prepared 12 percent of all individual U.S. tax returns for a total of over 13 million returns. We also transmitted over half the returns filed electronically last year with the Internal Revenue Service.

I would like to begin my testimony by stating that H&R Block would recommend the subcommittee support IRS' fiscal year 1996 budget request for both tax systems modernization and funding to combat fraud. After the subcommittee's hearing last year on tax refund fraud, we were pleased to see that the IRS' budget request included additional funding for staffing of refund fraud detection.

We encourage Congress to strongly consider making the investment IRS has requested for the purchase of computer software and hardware. Both refund fraud elimination and tax systems modernization efforts are extremely important investments in future IRS operations and their service to the American taxpayer.

In the 40 years we have been serving America's taxpayers, this is without a doubt the most difficult tax season in terms of our internal preparations and customer dissatisfaction. At H&R Block we

believe the reason we were the world's largest tax preparation firm assisting over 18 million taxpayers last year is because of our commitment to providing outstanding service to our clients.

This tax season we have received a substantial number of customer complaints due to the IRS inability to effectively communicate the procedural changes made this tax season. While the purpose of these changes was to eliminate tax refund fraud, millions of innocent taxpayers have been penalized and inconvenienced. It appears that the IRS is out to catch fraud rather than prevent the filing of fraudulent returns.

We are very concerned about tax refund fraud and support the administration's efforts to combat fraud by implementing procedures such as cross-checking of Social Security numbers. Historically, we have worked closely with the Internal Revenue Service criminal investigation officials in preventing and identifying potential fraud before the returns are filed.

Our quality control associates are trained to subject each W–2 brought in by our clients to a stringent review process. Our computer systems are programmed to check reasonableness between wages and withholdings on tax returns.

As I mentioned, millions of taxpayers are finding their tax refunds are being delayed because of changes in IRS policy that have not been effectively communicated. Let me give you some examples of individuals who are unaware of the recent changes in IRS procedure and were negatively impacted by these as a result.

One of our clients in Akron, Ohio, is an earned income tax credit recipient who needed her refund to bury her grandson, but has found out her full refund will be delayed. A taxpayer here in Washington, D.C., who has received EITC every year and uses it to pay his bills and daughter's college tuition received only a $100 refund and is waiting for the EITC portion of $2,000. Meanwhile, his bills are going unpaid and his interest costs are escalating.

Another taxpayer, a single parent, divorced with three children, this individual has moved several times in the last few years, misplaced birth certificates and has to use post office boxes to receive the EITC portion of her refund because her mail has been stolen from her. She is likely to be required to complete a two-page questionnaire and submit pages of documentation including obtaining and making a copy of her divorce decree, obtaining a copy of her post office box application, obtaining and making copies of birth certificates, obtaining and making copies of report cards or other school records for her two school-aged children, obtain a notarized statement from her day care provider, obtain her ex-spouse's Social Security number and address, and then mail all these documents in a package to the IRS within 30 days.

Normally, the filing season is very hectic for H&R Block, but in the past we have had the benefit of knowledge of the IRS rules and procedures well in advance. I want to cite some examples of new procedures we have had to implement this year.

For the first time, we have had to put into service a voice response unit to handle over 5 million phone calls that we haven't had in the past. For the first time, we have to keep copies of all W–2s. I personally had to sign 4,000 form 8633s twice for a total

of 8,000 signatures for our company-owned locations to receive their EFIN numbers so we could file electronically.

This year the IRS has decided to cross-check all Social Security numbers and names with the information on record and if a name and Social Security number don't match, then that certainly does create a problem.

In addition to that, the most people that have been severely hampered this year have really been the people who are receiving the earned income tax credit. Our numbers would indicate that approximately 30 percent of the electronically transmitted returns are having the EITC portion of their refund held for an additional period of time.

I also have some other recommendations enclosed in my testimony, Madam Chairman, that will talk about some of the recommendations we have to prevent fraud as well as the administration.

Chairman JOHNSON. We will have time to come back to those, Mr. Buckley.

[The prepared statement and attachment follow:]

Statement of Harry W. Buckley

President and Chief Executive Officer

of H&R Block Tax Services, Inc.

on Internal Revenue Service Budget for Fiscal Year 1996

and 1995 Tax Return Filing Season

Prepared for a Hearing before the House Ways and Means

Subcommittee on Oversight

Madam Chair and members of the Subcommittee, my name is Harry W. Buckley, President and Chief Executive Officer of H&R Block Tax Services, Inc. I appreciate the opportunity to appear before you today to present H&R Block's views on the 1995 tax filing season, IRS' efforts to combat refund fraud, and reform of the earned income tax credit program.

H&R Block is headquartered in Kansas City, Missouri and is the nation's largest income tax preparation firm. We serve approximately 1 out of 7 U.S. taxpayers. H&R Block has over 8,000 company-owned and franchised offices in the United States employing over 89,000 people during the tax filing season. Last year, we prepared 12% of all individual U.S. tax returns for a total of over 13 million returns. We also transmitted over 1/2 of the returns filed electronically last year with the Internal Revenue Service.

We have been serving America's taxpayers since 1955 when Henry Bloch, and his brother, Richard, founded the company. We have more experience working with and listening to middle and low income taxpayers than any other firm. As a result, we are in a unique position to learn of the particular problems and concerns faced by America's taxpayers.

I would like to begin my testimony by stating that H&R Block would recommend the Subcommittee support IRS' FY '96 Budget requests for both Tax Systems Modernization and funding to combat fraud. After the Subcommittee's hearing last year on tax refund fraud, we were pleased to see that IRS's budget request included additional funding for staffing of refund fraud detection. We encourage Congress to strongly consider making the investment IRS has requested for the purchase of computer software and hardware. Both refund fraud elimination and tax systems modernization efforts are extremely important investments in future IRS operations and their service to the American taxpayer.

In the forty years we have been serving America's taxpayers this is without a doubt the most difficult tax season in terms of our internal preparations and customer dissatisfaction. At H&R Block, we believe the reason we are the world's largest tax preparation firm, assisting over 18 million taxpayers last year, is because of our commitment to providing outstanding service to our clients. This tax season we have received a substantial number of customer complaints due to IRS' inability to effectively communicate the procedural changes made this tax season. While the purpose of these changes was to eliminate tax refund fraud, millions of innocent taxpayers have been penalized and inconvenienced. It appears that the IRS is out to catch fraud rather than preventing the filing of fraudulent returns.

H & R Block is very concerned about tax refund fraud and supports the Administrations' efforts to combat fraud by implementing procedures such as cross-checking social security numbers. Historically, we have worked closely with IRS' Criminal Investigation officials in preventing and identifying potential

fraud before the returns are filed. Our quality control associates are trained to subject each W-2 brought in by our clients to a stringent review process. Our computer systems are programmed to check the reasonableness between wages and withholdings on tax returns we prepare.

THE 1995 TAX FILING SEASON

As I mentioned, millions of taxpayers are finding that their tax refunds are being delayed because of changes in IRS policy that have not been effectively communicated. Let me give you some examples of individuals who were unaware of the recent changes in IRS procedure and were negatively impacted by these as a result.

One taxpayer served by our Akron, Ohio office is an EITC recipient who needed her refund to bury her grandson, but has found out that her full refund will be delayed.

A taxpayer here in Washington, DC who has received EIC every year and uses it to pay his bills and daughter's college tuition, received only a $100 refund and is waiting for the EIC portion of $2,000. Meanwhile his bills are going unpaid and his interest costs are escalating.

Another taxpayer is a single parent, divorced, with three children (including one pre-schooler in day care). This individual has moved several times in the last few years, has misplaced birth certificates, and has to use post office boxes because her mail has been stolen. For her to receive the EIC portion of her refund, she is likely to be required to complete a two page questionnaire and submit pages of documentation.

This will require her to do the following:

- Obtain and make a copy of her divorce decree.
- Obtain a copy of her post office box application.
- Obtain and make copies of her childrens' birth certificates.
- Obtain and make copies of report cards or other school records for her two school-aged children.
- Obtain a notarized statement from her day care provider.
- Obtain ex-spouse's social security number and address.
- Mail all these documents in a package to IRS within 30 days.

I want to call your attention to the fact that the 9598 form indicates that if IRS does not receive the information they have requested from the taxpayer within 30 days of date of the letter, the credit will be disallowed. The 30-day time frame seems unreasonable considering the paperwork that must be gathered to complete this form and the fact that the clock starts running with of the date on the letter, not upon taxpayer's receipt. We have been unable to find out if IRS is considering EIC validation for documentation received after the 30-day period for taxpayers with extenuating circumstances that prevented them from meeting the deadline.

Normally, the filing season is very hectic for H&R Block, but in the past we have had the benefit of the knowledge of the IRS rules and procedures well in advance. I want to cite some examples of new procedures we have had to implement this tax season.

- For the first time, Block has put into service a Voice Response Unit to handle over 5 million phone calls from clients checking on whether they qualify for a Refund Anticipation Loan (commonly referred to as a RAL).

- For the first time, I personally had to sign 4,000 (Form 8633's twice for a total of 8,000 signatures) for each of our

company owned locations to receive an EFIN number, so we could transmit returns automatically. We did not receive numerous EFIN numbers within the 45-day turnaround period as IRS promised, causing a delay in transmitting returns in January.

- For the first time, we must keep copies of all W-2's and supply a copy of the return when the clients signs the 8453 form, despite the fact that the taxpayer receives a copy two days later. This is reducing the productivity level of our tax preparers.

- H&R Block, as well as the rest of the tax preparation industry, is experiencing an increase in the cost of doing business which is attributable solely to changes in IRS procedures. Along with the duties involved preparing our clients returns, our tax preparers must spend additional time: 1) handling clients with problematic EIC returns for at least 6-8 weeks while they are waiting for their refund, 2) explaining new IRS procedures to clients, 3) dealing with clients' additional requests for information from IRS, and 4) helping clients resolve name and social security number problems on returns which have been rejected.

This year IRS has decided to cross-check all Social Security numbers and names with the information on record with the Social Security Administration. If a name and number on a tax return do not match the name and number in the Social Security Administration's records, the tax return is rejected by the IRS. While this may be an excellent procedure to implement to demonstrate IRS' commitment to combatting refund fraud, the message of this change did not get effectively communicated to the American public. As a result, taxpayers with legal changes in name (such as maiden name to married name), who have successfully filed for years, are having their tax returns rejected by the IRS due to a name and number mismatch. Therefore, the refunds are being delayed even though the taxpayers are using the same social security numbers they have used in the past. This is effecting millions of tax returns.

We have noticed two specific problems connected with the new social security number verification procedures:

- The Social Security Administration is not prepared to handle the volume of requests from taxpayers with Social Security number problems. In some cases in which taxpayers have lost their social security card, the wait for information was up to 2 weeks.

- There have been numerous instances of wrong information such as date of birth and spelling errors on last name of the social security records. In many cases, taxpayers are being penalized because of inaccurate data in the Social Security Administration's systems.

We recommend that for those taxpayers who have not yet filed their tax returns, electronic filing may offer a speedier solution as the IRS alerts the tax filer to any social security problems right away, eliminating a significant delay in processing the refund. Unfortunately, there is only one solution for a taxpayer who has already filed and has subsequently been notified by the IRS of a social security number problem. That taxpayer must revise the name with the Social Security Administration. An electronic return must then be retransmitted, when the name change has been verified, or in the case of a paper return, the taxpayer must respond to IRS correspondence about the accuracy of the name and or social security number.

H&R Block's customers with the greatest problem this tax filing season are those taxpayers filing for the Earned Income Tax Credit. Approximately 30% of the electronically transmitted

returns are having the EITC portion of their refund held for an additional period of time. This affects millions of taxpayers who qualify for, and depend on, this credit. Only after the IRS examines and verifies the Earned Income Tax Credit claim will they forward the refund to each taxpayer in one of four ways. The IRS will: 1) issue a refund, less the Earned Income Tax Credit amount, right away; 2) delay a refund for up to 8 weeks while they review it; 3) send a questionnaire to be filled out and returned by the taxpayer before issuing a refund; or 4) issue a refund without delay.

As a result of Treasury's decision to eliminate the direct deposit indicator, banks have been forced to increase their Refund Anticipation Loan prices, as well as their credit criteria which has angered many more taxpayers. As with other procedural changes made by IRS this tax year, while the intent of reducing fraud is commendable, the late announcement of such a significant change has caused significant financial hardship for taxpayers who are least able to afford it. This year the fees for RALs depend on the refund size, and on average the amount has doubled and range from a minimum of $29 to a maximum of $89. When the bank denies a RAL request, Block will waive its electronic filing fee of $25 for a Block-prepared return and $35 for a non-Block prepared return. In its place a service fee of $5 and $10, respectively will be charged.

EFFORTS TO FIGHT ELECTRONIC FILING FRAUD

Prior to tax season 1993, H&R Block established our own fraud prevention plan targeted at electronically filed returns. During the 1995 season, Block continues to be diligent in its efforts to maintain the following action plan to prevent the filing of fraudulent tax returns.

- Because so many fraudulent returns include first time Earned Income Credit (EIC) claims, Block does not allow banks making Refund Anticipation Loans (RALs) to Block clients to do so for any taxpayer who is eligible for EIC but did not file a tax return the previous year.

- Block subjects all W-2s to a stringent review process. All electronically filed returns containing a non-standard (substitute, handwritten, typewritten, or altered) W-2s are carefully reviewed before the returns is transmitted to the IRS. The FICA and Medicare withholding amounts are verified for accuracy. When it is suspected that a W-2 is fraudulent, Block verifies the taxpayer's employment with the employer listed on the suspect W-2. If employment cannot be verified, Block notifies the taxpayer that Block will not electronically file the return.

- Block does not allow banks making RALs to do so for any taxpayer whose only income is from Schedule C.

- Block compares the amount of income tax withholding on each Form W-2 with gross wages to determine whether the withholding amount is "reasonable" for the amount of wages.

- If Block detects or suspects fraud on any return, it sends a letter to the taxpayer explaining that the return contains discrepancies that must be cleared up before the return can be electronically filed. If the taxpayer does not respond satisfactory to the request for additional information, Block brings the situation in question to the attention of the Criminal Investigation Division of IRS.

RECOMMENDATIONS FOR REFUND FRAUD PREVENTION

After reviewing the results of this Subcommittee's February

10, 1994 hearing on tax return fraud, Block updated our fraud prevention plan. Because H&R Block shares the IRS' concerns, we have shared our detailed plan with them and are pleased to see some of our suggestions have been implemented. Our recommendations focus on four major points of implementation:

- impose higher standards on Electronic Return Originators;
- produce a cooperative public relations campaign between the IRS, CID, and Electronic Return Originators;
- require additional process controls by Electronic Return Originators; and
- enhance IRS system checking.

SUGGESTIONS FOR EASIER ADMINISTRATION OF EIC AND FRAUD REDUCTION

As you requested in your letter Representative Johnson, I would make some specific recommendations to simplify the administration of Earned Income Tax Credit and to reduce fraud within that program.

- Accounts (SSNs) for taxpayers whose EIC is delayed but ultimately paid, either through back end verification by IRS or acceptance of Form 9598, should be flagged in the IRS system as "good accounts." Based on this "flag," in future years the IRS would accept Schedule EIC as filed, thus eliminating EIC stripping and the requirements to complete Form 9598 and/or refund delays for these taxpayers.
- Advance EIC -- guarantee no delays in processing EIC portion of refund for taxpayers who receive advance payments of EIC from their employers.
- To avoid refund delays while preventing false claims, the IRS could require all taxpayers who are claiming EIC, head of household status, and dependents for the first time to file applicable documentation with their returns. This could include (as applicable) a dependency support worksheet, head of household worksheet, and EIC Questionnaire, as well as copies of proof documents. The confirming data could then be entered in the IRS computers. Once a taxpayers gets a "clean bill of health," he or she should be required only to reaffirm the personal data (and any changes) on a simple, one-page declaration form that would be filed with the return each year.
- Require submission (electronically or in paper format) of Earned Income Credit Worksheet or revise the EIC Form to include that information (similar to a form H&R Block designed and proposed to IRS).

CONCLUSION

I would like to close my remarks by offering H&R Block's technical expertise in tax return preparation to the members of the Subcommittee and Administration. As I have stated, H&R Block is committed to eliminating tax refund fraud, and is available to assist you in these efforts. Thank you.

Schedule EIC — Earned Income Credit — 1994

Name(s) shown on return | Your social security number

You cannot take this credit if:
- your return is for less than 12-month period (unless the short period is due to the taxpayer's death); or
- your filing status is married filing a separate return; or
- you are excluding any foreign earned income by filing Form 2555 or 2555-EZ with your return.

You may be eligible to take an earned income credit if:
- your adjusted gross income (line 16, Form 1040A or line 31, Form 1040) and
- your earned income (line 7, Form 1040A or lines 7, 12, and 15, Form 1040, *plus any nontaxable earned income from your employer*) are *both* less than:
  - $23,753 if you have one qualifying child; or
  - $25,293 if you have two or more qualifying children; or
  - $ 9,000 if you have no qualifying children.

To determine whether or not you can take an earned income credit:
- Complete Part I if you believe you may have a qualifying child; or
- Complete Part II if you know you don't have a qualifying child.

Part I: Earned Income Credit For Taxpayers With a Qualifying Child

1a Did a child live with you in the United States for more than half of 1994 (all of 1994 if the child is a foster child), or for the part of the year he or she was alive if the child was born or died during the year? . . . . . Yes ☐ No ☐

b Is the child your son, daughter, adopted child, grandchild, stepchild, or foster child? (Married child must be your dependent or would be except you gave the exemption to the other parent.) . . . . . Yes ☐ No ☐

c At the end of 1994 was the child under age 19, or under age 24 and a full-time student, or any age and permanently and totally disabled? . . . . . Yes ☐ No ☐

If you answered *yes* to all parts of question 1, go to line 2. If you answered *no* to any part of question 1, you do not have a qualifying child but, if your income is less than $9,000, go to Part II.

2 Are you a qualifying child of another taxpayer? . . . . . Yes ☐ No ☐

If *yes*, do not complete the rest of the form. You cannot claim an EIC. If *no*, go to line 3.

3 Did you and another taxpayer (other than your spouse with whom you are filing a joint return) live in the same home for over one-half of 1994 and have the same qualifying child(ren)? . . . . . Yes ☐ No ☐

If *yes*, enter the amount of the other taxpayer's adjusted gross income _____ and go to line 4. If *no*, go to line 5.

4 Is your adjusted gross income more than the amount on line 3? . . . . . Yes ☐ No ☐

If *no*, do not complete the rest of the form. You cannot claim an EIC. If *yes*, go to line 5.

5 Enter the requested information for the eligible child (or for two of the children if you have two or more eligible children). Then, go to Part III to figure your credit.

(a) Child's name (first, initial, and last name)	(b) Child's year of birth	For a child born before 1976, check if child was: (c) a student under age 24 at end of 1994	(d) disabled	(e) If child was born before 1994, enter the child's social security number	(f) Child's relationship to you (for example, son, grandchild, etc.)	(g) Number of months child lived with you in the U.S. in 1994
	19					
	19					

Part II: Earned Income Credit For Taxpayers With No Qualifying Child

6 Are you (or your spouse) a qualifying child of another taxpayer? . . . . . Yes ☐ No ☐

7 Were you a dependent eligible to be claimed on another taxpayer's 1994 return? . . . . . Yes ☐ No ☐

8 Was your main home located outside of the United States for 6 months or more during 1994? . . . . . Yes ☐ No ☐

9 Were you (and your spouse if married) under age 25 or older than age 64 at the end of 1994? . . . . . Yes ☐ No ☐

If you answered *yes* to any of the above questions, you do not qualify for the credit. Do not complete the rest of the form. If you answered *no* to all of the above questions, go to Part III to figure your credit.

Chairman JOHNSON. Mr. Martin.

STATEMENT OF MICHAEL MARTIN, ENROLLED AGENT, NATIONAL ASSOCIATION OF ENROLLED AGENTS

Mr. MARTIN. Thank you, Madam Chairman. My name is Michael Martin. I am an EA (enrolled agent) practicing in the Washington, D.C., area. I am representing the National Association of Enrolled Agents of about 9,000 members, all of whom are licensed by the Treasury Department to represent taxpayers before the IRS. If I can digress in this written comment a little bit, I think we can save some time.

I don't think anyone here was on this subcommittee in 1978. I happened to testify before this subcommittee in 1978 when the tax preparer penalties came into being, and they came into being for exactly the reason we are talking about now, and that is refund fraud. What was happening then is financial institutions were offering loans based on a potential refund to taxpayers and it was found out through audit that the tax preparers were inflating the number of exemptions, inflating itemized deductions, claiming dogs, parakeets, and everything else on tax returns in order to get a bigger refund and write a bigger loan. That whole process was stopped in 1978 with the passage of the Internal Revenue Code, section 6694 through 6696 and 6701.

In the nineties, the IRS was desperate to find some way to encourage people to use the electronic filing, and I think that is something you have to realize. There is no benefit to the taxpayer to file their return electronically, per se. It costs them more money. They are charged a fee to file their return electronically.

If they get their refund back faster, that is great. That is the benefit. The industry came to the IRS and proposed the idea of the refund anticipation loan with the direct deposit indicator. So we see that the IRS has come full circle, I think, in stopping what was in 1978 the refund anticipation loan, to in the nineties early nineties encouraging it.

It has gone, so far as it came to my attention last year, that one district office of the IRS sent out a letter to all real estate agents in that district encouraging them to become electronic filing centers. They said the only thing you have to have is a computer and a 2400 baud modem. You don't need to know anything about taxes or have any licensings or anything. Just send us your application and you can file tax returns electronically.

We think there are two solutions to this problem long term. One is the tax system modernization. But I have to tell you, I am appalled to hear that the IRS is looking at a system that doesn't talk to each other. I have to deal with this system every day, a system that doesn't talk to each other.

There is a system called the IDRS, the Information Document Retrieval System, and the ACS system, Automated Collection Service, which is the accounts receivable system. They don't talk to each other. They are not even on the same computer, not on the same terminal. If I am talking to a revenue officer on the telephone and they are in front of the ACS computer, if they can't find my

power of attorney, if they can't find my correspondence, they have to go to the IDRS system, which is at the other end of the room. They have one terminal—I am only talking about the Baltimore district now—to access that other computer.

To hear that the collection division is going to have another new system that doesn't talk to the main system, it doesn't help us at all in trying to solve taxpayers' problems with their accounts receivable.

But we also have to bring tax system modernization down to the local level. I am constantly frustrated, as are many of our members, with the fact that many IRS district offices do not have a fax machine readily available so we can fax information to them.

In this day and age, it is unheard of for an office, a business office not to be able to receive a fax. Many of us in my industry, if we have to fax a canceled check to the IRS we can't do so.

The other thing that we think is very important in the long-term solution is the universal licensing of tax return preparers and we have included documents from the Commissioner's advisory group recommending this. Their subgroup, as well as the GAO study based on the 1988 taxpayer compliance measurement program, showed that the amount of tax fraud and tax errors among those people who are licensed EAs, CPAs, and attorneys was much lower than the incidence of fraud among unlicensed commercial preparers.

Short-term solutions—we think that the IRS can do more short term by better screening of the tax returns. If people have a history of filing earned income credit claims, those returns probably should not be scrutinized as carefully as other ones claiming the earned income credit for the first time.

I would be happy to take any questions that you have.

[The prepared statement and attachment follow:]

STATEMENT OF MICHAEL MARTIN, ENROLLED AGENT
NATIONAL ASSOCIATION OF ENROLLED AGENTS

Madam Chair, Members of the Subcommittee, thank you for your invitation to testify on behalf of the National Association of Enrolled Agents, regarding the topic of income tax refund fraud, and specifically the delay some taxpayers are experiencing in receiving their refund checks due to the IRS's "Questionable Refund Program".

This testimony is being presented on behalf of approximately 9,000 members of the National Association of Enrolled Agents (NAEA). Members of NAEA are professional individuals whose primary expertise is in the field of taxation. They have established this expertise by either passing the Internal Revenue Service's comprehensive two-day examination on federal taxation or by serving as an IRS employee in an appropriate job classification for at least five years. NAEA members maintain this level of expertise by completing at least 30 hours of continuing professional education each year. As you may know, our members are the only classification of tax professional who are licensed by the Treasury Department. Our members represent more than four million (4,000,000) individual and small business taxpayers annually. It is in our role as the voice for the general taxpaying public that NAEA provides this testimony.

HISTORICAL PERSPECTIVE

In the late 1970's the tax preparation industry was rocked by a scandal in some ways similar to the one disclosed last year. It seems that many financial organizations offered tax preparation services to clients. As an incentive to potential as well as existing clients these institutions offered to loan the amount of the refund to the taxpayer as soon as the return was completed. The taxpayer would then endorse the refund check in favor of the lender in order to satisfy the debt.

It was found that because the tax preparers were paid more for placing loans than preparing the tax returns, they were inflating deductions and exemptions thus producing refunds larger than actually due.

As a reaction to this abuse, Congress enacted the Tax Preparer Penalties sections of the Internal Revenue Code (IRC Sections 6694-96 & 6701) which punishes preparers for filing false returns, negligent preparation or endorsing a refund check.

In the 1990's the IRS was seeking ways to encourage taxpayers and tax preparers to participate in the electronic filing program. The IRS has maintained that the ELF program reduces its expenditures for processing returns and also increases the accuracy of those returns.

Electronic filing gave rise to a new industry composed of many more than the traditional tax return preparers. Rushing to seize this new business opportunity were third party transmitters of returns, collection sites for preparing and transmitting the returns, and what became knows as "refund mills". In fact, as recently as 1993, one District Office of the IRS sent letters to all of the real estate agents in the District encouraging them to offer electronic filing services to their clients. The letter stated that all they needed was a 2400 baud modem on their computer. No tax knowledge was required, nor was any licensing, registration or regulation.

When the concept of the Refund Anticipation Loan (RAL) was conceived by the newly emerging electronic filing transmitter industry, it was not quashed by the IRS. The IRS indeed adopted and supported the program. The IRS agreed to further facilitate the RAL program by issuing Direct Deposit Indicators (DDI) to verify to the lenders that no offsets would reduce the amount of the claimed refund and thus essentially guarantee the loan.

Thus in their zeal to expand the use of electronically filed returns, the IRS promoted the growth of a new industry that was not subject to many of the preparer penalty rules adopted in the late 1970's to preclude the problems we see today. The IRS either did not or could not set up the systems needed to monitor not only the returns being filed but the electronic transmitters of those returns.

PROBLEM

In fifteen years, we have come full circle from the IRS discouraging the use of refund anticipation loans because of the potential for abuse to the IRS creating the environment where refund fraud could exist by encouraging and fostering the use of RALs. The fact that approximately 70% of electronically filed returns request RALs shows the popularity of that program. In fact, because of that popularity, the very future of the Electronic Filing Program may be in jeopardy unless a way is found to bring the program back to its performance of the last two years. The question now is how to curtail the filing of fraudulent tax returns while at the same time meeting the demand that has come into existence for rapid refunds.

LONG TERM SOLUTION

NAEA suggests that there are two solutions to this problem which will work in tandem. The first is enhancing the IRS's ability to perform the necessary checks by computer. The second would be to institute a regulation requirement for all tax preparers.

We realize that this subcommittee is not specifically charged with the IRS budget. However, we wish to take this opportunity to recommend to each member of the subcommittee the real long-term solution to this problem. That is the IRS's Systems Modernization Program. The funding of this program will give the IRS the computer capability to perform SSN matching and verification in a short enough period of time to issue the refunds promptly while simultaneously safeguarding the tax system from the type of refund fraud experienced during the last two years.

We believe the second part of the solution would be the universal regulation of tax return preparers. We cite the report of the Sub Group of the Commissioner's Advisory Group dated January 18, 1995. (A copy of that report is attached.) In that report, the sub group cited the statistics that 96.5% of all accuracy related tax preparer penalties were assessed against commercial tax return preparers who were neither EAs, CPAs nor attorneys. The sub group's report also cited a GAO study based on the 1988 Taxpayer Compliance Measurement Program data which showed compliance by commercial, unlicensed tax return preparers significantly lower than other groups. Finally, the sub group cited the experience of Oregon and California which have tax return preparer licensing programs and have found reduced incidence of fraud.

We, therefore, urge this subcommittee to support the CAG's recommendation to begin a program of registering and regulating commercial tax return preparers.

SHORT TERM SOLUTIONS

The IRS has already taken steps to curtail the opportunities for fraud in the electronic filing program. New this year are procedures requiring those preparers who are not currently regulated and held to the standards of Circular 230, and who participate as electronic filers, to submit fingerprints and pass a credit check.

The IRS has also instituted a program of surprise inspections of offices and files of Electronic Return Originators (ERO) who are electronic filers. These inspections are random and are not predicated on any evidence or suspicion of wrong doing on the part of the ERO. These inspections are very time consuming for the ERO and can completely disrupt a whole day of appointments. We question the IRS's right to "browse" through the records of any taxpayer whose return was prepared by the office being inspected. If these investigations could be focused on practitioners where there was a greater likelihood of uncovering erroneous filing practices, rather than simply at random, they might be more effective. After all, the IRS's examination program focuses on returns where there is a larger possibility of error. Why not apply the same standards to the review of electronic filers?

The IRS has instituted the Questionable Return Program where they are performing more verification on the types of returns which in the past accounted for the preponderance of the refund fraud. This program is causing a great hardship among the legitimate filers of refund

returns and those claiming a refund based on the Earned Income Credit. These individuals have come to count on the Rapid Refunds promised to them over the last five years. The IRS created a demand for the product, and has now cut off the availability of that product.

One possible intermediate solution would be to process in an expeditious manner those returns where the taxpayer's are using the same name, address and social security number as on previous returns, where the taxpayer has a history of claiming the Earned Income Credit, has the same employer and has a history of receiving refunds. Thus, only those returns that showed a variation from the normal and customary pattern of filing or were claiming the Earned Income Tax Credit or other refunds for the first time would be selected for greater scrutiny. This would allow the IRS to process refunds to many taxpayers quickly, fulfilling the promise of the Electronic Filing Program while maintaining safeguards against questionable claims.

Another suggestion would be that since several reports show a significantly lower incidence of fraud and negligence among licensed tax professionals, electronic filing originator status should be limited to those practitioners already licensed and supervised by the IRS.

Another alternative would be to require that Electronic Filing Originators, not covered by Circular 230, post a bond as well as be licensed by the IRS.

The effect of this slow down in processing returns has had a dramatic effect on the tax filing system. A recent report states that electronically filed return usage is down 25%-30%. A recent article in the Wall Street Journal reports that rejected return frequency is up 25%. This is occurring even though many of the returns contain information similar to last year and were filed electronically in previous years and accepted.

We do not believe that there is one easy solution to the problem of refund fraud, especially with the age of electronic filing. However, a combination of the above suggestions should serve to stem the hemorrhage of fraudulent refunds that have been issued during the last several years as well as speed the processing and issuance of refunds to those taxpayers most in need.

NAEA supports all efforts to identify and eliminate fraud in the tax filing system. We believe that the tax professional community is the first line of defense in return preparation fraud detection. We are ready to offer our members' support in this effort. Again, the members of NAEA thank you for this opportunity to testify on this important issue. We offer our assistance to provide any additional information raised by these comments or other areas of concern.

REGULATION AND REGISTRATION OF COMMERCIAL TAX RETURN PREPARERS

JANUARY 18, 1995 COMMISSIONER'S ADVISORY GROUP MEETING

In 1989, the Commissioner's Advisory Group studied the matter of regulating and registering commercial tax return preparers. At the time, the reasons for considering this matter included the following:

1. Any person, regardless of training or experience, may prepare income tax returns for a fee.

2. Commercial tax return preparers generally are not required to subscribe to any rules of professional conduct or professional responsibility.

3. The complexities of the tax laws are such that doubts are raised relative to the overall competence of commercial tax return preparers.

All of these concerns are still valid. In addition, the February 1994 hearings on the IRS Refund Fraud Strategy, held by the Subcommittee on Oversight of the House Ways and Means Committee, indicate a strong need to address the competence and integrity of the commercial tax return preparer community. In fact, close examination of the testimony provided at these hearings reveals support for the regulation and registration concept.

In response to questions posed to them during the hearing, two witnesses who were convicted of preparing false Federal income tax returns made the following comments:

"I am a tax preparer, but I didn't need to apply for any tax preparer (sic)..."

"I filled out 1040s and signed as the preparer of the returns. That is all that is necessary in the system."

"The idea would be for tax preparers, if they (IRS) could oversee them better. I am not an enrolled tax preparer (sic) with the IRS. I can go ahead and sign someone's return. Anyone in this room could sign another person's tax return as information supplied to them to the best of their knowledge and sign a return as a preparer."

The Subgroup also examined preparer penalty data and found the number of return preparer penalties assessed for fiscal year 1993 numbered 2,392. Interestingly, only 80 of these were assessed against Enrolled Agents, attorneys and CPAs (practitioners regulated under Circular 230). Thus, it can be inferred that 96.65% (2,312) of all return preparer penalties assessed for fiscal year 1993 were assessed against commercial tax return preparers. The 1989 CAG looked at similar data from fiscal year 1988 which indicated that 90.30% of all return preparer penalties assessed were assessed against commercial tax return preparers.

The Subgroup likewise took into consideration the recently released General Accounting Office (GAO) report which analyzed the compliance rates of sole proprietors. This report included a break-down of voluntary compliance, reported as a percentage, by type of preparer and was extracted from the 1988 Taxpayer Compliance Measurement Program (TCMP) data. The voluntary compliance percentage for the "other paid preparers" and "National Tax Service" categories, which include commercial tax return preparers, was among the lowest.

Finally, the states of Oregon and California currently have licensing programs in place for tax return preparers. The Ethics in Business Practices Subgroup has solicited input from the administrators of each of these programs to determine their success or failure. The Oregon State Board of Tax Service Examiners responded to several questions we posed to them. These questions and answers are attached to this report as Appendix A. In light of the current concern regarding refund fraud, the statement included in answer #2 "Since licensees can be easily found, fraud is generally low." is particularly interesting.

Having concluded that the regulation and registration of commercial tax return preparers is highly desirable, the Ethics in Business Practices Subgroup presents the following model program to regulate and register commercial tax return preparers.

DESCRIPTION:

Circular 230 would be amended to prescribe rules for the registration of "Commercial Tax Return Preparers".

1. "Commercial Tax Return Preparer" (CTRP) defined:

   The current definition of income tax return preparer found in Internal Revenue Code section 7701(a)(36)(A) would apply. Practitioners currently covered under Circular 230 (Enrolled Agents, attorneys and CPAs) would be exempt.

2. Registration and phase-in period:

After the approval and implementation of this proposal, anyone meeting the definition of CTRP would have one year to register with the Internal Revenue Service without providing proof of continuing professional education (CPE). This one year period would constitute the phase-in period. The group of CTRPs, who would be grandfathered into the program, would be obligated to meet all the requirements of registration renewal as set forth below.

3. Post phase-in period:

Persons desiring to register for the first time after the first year of the program would be required to meet the criteria listed below and submit proof of satisfying a minimum of 24 hours of CPE during the 18 months immediately preceding the receipt of the application for registration. Such proof, the completed registration form and required fee would be submitted to the Internal Revenue Service for acceptance.

4. Criteria for CTRPs:

A. Be not less than eighteen (18) years of age;

B. Continuing professional education requirements must be adhered to as follows:

1. A minimum of 48 hours of approved CPE over a three year period with a minimum of 8 hours of CPE in any one year.

2. Qualifying CPE will be that which meets the definition of "Continuing Professional Education" as found in Treasury Department Circular 230, section 10.6(f).;

3. Evidence of continuing professional education and a renewal application would have to be submitted every three years commencing with the third anniversary of the initial registration.

C. The information submitted on each application for the registration would be subject to IRS verification and investigated in a manner consistent with that of applications for enrollment to practice before the IRS;

D. CTRPs would be subject to the standards set forth in Circular 230;

E. Violations of ethical standards would result in the assessment of monetary penalties as authorized and/or prohibition from further tax return preparation;

F. Limited fees would be paid for registration to make the program self-funding. A study is requested to ascertain the minimum fee requirement;

G. Opportunities for non-English speaking preparers will be made available to accommodate registration and continuing professional education.

H. The program would be administered by the IRS Office of Director of Practice with strong support and referrals from the District Directors' offices.

SUMMARY:

This proposal has evolved after numerous meetings and extensive discussion and study. We recognize that the individuals covered by this proposal provide a vital service to the public. As a result, this program is not intended to limit or reduce the number of available tax return preparers. We have eliminated the second level of CTRP which appeared in our proposal presented at an earlier CAG meeting. It became obvious that the second tier of Advanced CTRP posed many problems including setting limits and/or assigning different responsibilities to each level. We reached a unanimous conclusion that eliminating the Advanced CTRP would enable the program to achieve its goals, simplify its administration and minimize the disturbance to the present system.

Chairman JOHNSON. Thank you both for your very useful testimony.

Mr. Buckley, if you want to just briefly run through your recommendations, I would be interested in hearing those.

Mr. BUCKLEY. OK. Basically we have a four-step program that we suggest. One is to impose higher standards on electronic return originators which is much similar to what Mr. Martin just mentioned. Also, to produce a cooperative public relations campaign between the IRS, the Criminal Investigation Division, and the electronic return originators; require additional process controls by chronic return originators; and to enhance the IRS system checking.

Chairman JOHNSON. As to the current filing season, are there any changes that could be made midstream that might help straighten out some of the problems without reducing the chances of eliminating fraudulent claims?

Mr. BUCKLEY. I would think at this point in time that the IRS would have sufficient returns there that there would be some that they could start processing a lot quicker than what they anticipate, so that many of these taxpayers who are not used to waiting the 8 weeks to get their refunds or maybe 12 weeks if they get this additional form could possibly be served better.

Chairman JOHNSON. I do think that the wait of 2 months while you do point to some real cases of hardship, in general the wait of 2 months is not nearly as great a hardship as the fraud associated with this program and the cost to the taxpayers. So I think this was a necessary step to go through. Why is it that your industry wasn't better prepared for what was going to happen this season? It does appear that notice was given.

Mr. BUCKLEY. I don't feel that we were given proper notice as to the scope of the problem. We knew that they were going to be looking at earned income credit returns. The magnitude of the number of refunds that they have stopped is obviously a lot larger than what we anticipated. I agree with your former statement, Madam Chairman, that we need to do something to stop fraud and 2 months' wait is not that bad. The problem is I think taxpayers and tax preparers should have been able to warn those people much sooner than having to come into our office and then startling them that there may be a problem.

Chairman JOHNSON. Did the tax preparers underestimate the number of people whose Social Security number was inaccurate? I mean you certainly must have known this from past experience, or did you underestimate the number of people that were involved in the EITC?

Mr. BUCKLEY. I think——

Chairman JOHNSON. Both of which facets, seems to me, you would have known from your past experience.

Mr. BUCKLEY. Well, in the past when a return was submitted to the IRS, the primary Social Security number was checked and verified. This year, not only are they checking the primary, but they are also checking the spouse and the children and everyone else that is on the return. Our experience would show that many, many taxpayers out there are filing returns with the identical Social Security numbers that they have used for years. All of a sudden, they

know they have a problem either when the return is rejected when you file electronically or they will receive a notice back from the Internal Revenue Service. So it is very difficult to explain to somebody that you really need to go and check your Social Security cards.

Particularly what we find today are that many spouses who when they got married did not change their name with Social Security records and as a result they have been filing as Mrs. Johnson or Mrs. Buckley all these years, and yet this year they file with that same Social Security number that they have been using and then the return is rejected. So it is not until after the fact that these people understand that they really have a problem.

In regard to your question with the earned income credit, we certainly did underestimate, and I think justifiably from the IRS' point of view, that they would not be stopping as many returns. It just seems incredible that there are so many—such a broad brush has been used to stop the number of fraudulent returns which are currently out there.

Chairman JOHNSON. Well, could you be more specific about this broad-brush issue. Certainly claiming more children, more deductions than you are entitled to, is one cause of a lot of fraud.

Mr. BUCKLEY. Well, Madam Chairman, we have been using the term, "fraud" rather loosely here, as has been indicated from the subcommittee from last year's testimony when I believe it was identified then as problematic refunds rather than fraud, and that problematic does obviously contain some amount of fraud. I think the issues that we have recommended to the IRS—I think some of the things they have done this year as far as having us all get fingerprinted and get an EFIN for each location. I think these are commendable. I think checking Social Security numbers is commendable. But I don't think there is a need out there to stop these millions of returns when you didn't tell the people up front this is what you were going to do.

Chairman JOHNSON. Now, I thought they did tell the people up front this is what they are going to do. The people don't necessarily understand the dimensions of this, maybe they didn't know the dimensions of this, but can you honestly say that people weren't informed?

Mr. BUCKLEY. I can say that in the tax booklet which I think would be the major publication and our major communication that a taxpayer would have a hard time in reading that. There is one small line in there that says that some returns that are filed electronically will be held up to make sure they are accurate. I think that small little blurb in there, as well as in the Commissioner's letter to the taxpayers, which says you must use the proper Social Security numbers, is being taken lightly by taxpayers, as I mentioned, because they have been using these same Social Security numbers for a number of years.

It would seem to me that if they did use these same Social Security numbers this year as they have in the past, that there should have been some way that the IRS could have notified these people last year saying that this Social Security number doesn't belong to you and you are going to have to get this fixed before next filing season.

Chairman JOHNSON. I have seen their letter and it could have been stronger. It could have been stronger in the sense of saying there is a problem with your Social Security number. You are going to have a hard time this filing season. Please check this and this is what you are supposed to do to check it. But many of the people you deal with have never read those directions. They count on you to read those directions. Did you work with your clients to be much more serious about Social Security numbers and about earned income tax credit documentation?

Mr. BUCKLEY. We have worked with our taxpayers on a daily basis in many cases. The problem with the Social Security number issue, as I mentioned, is that until we file electronically and it is rejected, that is when we can tell them they have a problem. It is a very difficult mission to try to tell somebody that there is a possibility that these Social Security numbers are not correct.

Chairman JOHNSON. So it wasn't really a problem for everyone to pick up until the system spit out that yours was not a correct Social Security number.

Mr. BUCKLEY. Right.

Chairman JOHNSON. Nonetheless, it is an important error to correct and will enable us to give a far better quality system. Next season it shouldn't be as much of a problem.

Mr. BUCKLEY. I would hope not.

Chairman JOHNSON. Thank you. Mr. Martin do you have anything you would care to add?

Mr. MARTIN. Well, we—the press release that I saw from the IRS announcing the dual refund system was dated, I believe, December 28. By December 28 most practitioners have already made plans, got our client letters out. Hopefully, our clients read our letters a little bit more than they read the letter from the Commissioner where we alert our clients to things like this. On December 28 our letters are by and large already out. Taxpayers have their information.

Chairman JOHNSON. But you were notified December 28.

Mr. MARTIN. The press release from the IRS that I saw was dated December 28. Yes, ma'am.

Chairman JOHNSON. The IRS was not specific about that earlier, so I was interested.

Mr. MARTIN. I know. The other thing that is possibly unfortunate for one reason or another is that the tax press did not pick up on that press release until around the first of February.

Chairman JOHNSON. That is interesting.

Mr. MARTIN. So most of us read some kind of a weekly journal of tax happenings and when we pick that up, OK, we know there could be a problem here. But, again, by early February we are already seeing clients and clients have been promised—there have been promises. The service has been promising for 5 years what I said in the written statement.

If you file your return electronically, you will have a very short turnaround for your refund. Now all of a sudden, just to turn off that spigot, I think, does create a serious hardship, and it is a hardship that the practitioner community has had to bear, because the taxpayer doesn't go to the IRS and yell and scream at the revenue officer and they don't have a chance to—they won't scream at

the Commissioner. They come to my office and they come to the H&R Block office and they yell and scream at their preparer saying, why haven't I gotten my refund check?

Chairman JOHNSON. I think your comments in your testimony about the history of this issue were very, very instructive.

Mr. MARTIN. I think the IRS should take some of its TSM and buy a historian so they don't keep making the same mistake.

Chairman JOHNSON. I assume you think the elimination of DDI is a good thing so that banks do that checking themselves.

Mr. MARTIN. I think so, yes. It complies with the law, though. The code, as it currently says, a practitioner, a preparer cannot endorse a taxpayer's refund check. That is, in fact, a $500 fine. If I would prepare your tax return, receive your refund check and deposit it right in my account, I would be fined $500.

The way the rapid refund or the refund anticipation loan works, that check comes into the taxpayer's bank account and then is electronically debited. It is only one step removed from the practitioner actually endorsing the check. It is a system fraught with danger.

Chairman JOHNSON. Thank you.

Mr. MARTIN. The other thing that we suggested which I think is a short-term solution is bonding. I mean this is—if we are talking about running the government as a business, if I am dealing with a contractor that is handling that amount of money, we have to realize that most of the refund fraud has emanated not from the taxpayer because they don't have access to the system. It is emanating from preparers who have access to the computer and the modem and the EFIN number, so to these people it is only good business.

Chairman JOHNSON. Mr. Hancock.

Mr. HANCOCK. Thank you, Madam Chairman.

What percentage of your clients file their returns electronically?

Mr. MARTIN. Of mine?

Mr. HANCOCK. Well, both of you probably have about the same percentage.

Mr. MARTIN. No. I don't participate in electronic filing programs at all, personally I do not. Many of our members, probably 50 percent, a survey we did recently about 50 percent or more of our members do participate in electronic filing programs and of them—of those people, I am trying to remember the statistics, about 40 percent of the returns were filed electronically.

Mr. HANCOCK. Do your clients ask you to participate in it?

Mr. MARTIN. No, sir.

Mr. HANCOCK. Do you have a particular client base of some type?

Mr. MARTIN. My client base is mostly professional upper income. They are not getting refunds, and if they are getting refunds, they are not worried about getting them in 2 weeks, 6 weeks, or 8 weeks. I personally have always had problems with the viability of the system and I elected never to participate in it.

Mr. HANCOCK. OK. Mr. Buckley.

Mr. BUCKLEY. We transmitted last year over 7½ million returns electronically. We transmit about 40 percent of the returns that we actually prepare, and we also transmit several million returns for people who have their returns prepared elsewhere or do it themselves.

Mr. HANCOCK. OK. Now, what do you mean you transmit. They complete their own return and bring it in to you and you transmit it electronically, is that correct?

Mr. BUCKLEY. That is correct.

Mr. HANCOCK. Do you have any idea how many of these clients apply for the refund anticipation loan, what percentage of your clients?

Mr. BUCKLEY. I would say certainly a majority of them, maybe 75 percent.

Mr. HANCOCK. Wait a minute. Are you talking about the one that is filed electronically? Seventy-five percent of them ask for these loans.

Mr. BUCKLEY. Approximately.

Mr. HANCOCK. What percentage of your profitability is determined by your fees that you charge on these loan applications?

Mr. BUCKLEY. We don't—we receive a very small fee off the actual loan. We charge a transmission fee whether you get the loan or you don't get the loan. In other words, for the clients who want to come in and just file electronically, they would pay the same price transmission fee as a client who comes in and wants the loan as well.

Mr. HANCOCK. What is that transmission fee?

Mr. BUCKLEY. We charge $25 transmission fee if the return is prepared by H&R Block and $35 if the return is prepared by themselves or someone else.

Mr. HANCOCK. Do you have any idea about the default rate on these anticipation loans, do you have any information at all on those?

Mr. BUCKLEY. No, sir, that is strictly done by the bank. The banks provide those loans.

Mr. HANCOCK. In December 1994 when they announced that there was going to be a slow down because they were going to be checking into fraud, did your organization take any major steps to start telling people that they might be subject to the slow down on the earned income tax credits?

Mr. BUCKLEY. Starting when we opened our offices in January, at that time even we did not know who or had no idea as far as the filters and screens that were going to be in place this year to be able to tell anybody that their returns could be delayed. In fact, when the first IRS money came back, it appeared to us that none of the clients had been—that none of the EITC had been stripped.

The second week when refunds started to hit, at that time we were notified by the bank who handles our refund anticipation loans that they were seeing refunds—the refunds not containing the earned income credit.

At that time, we immediately provided every customer who has earned income credit a letter which told them of the four possibilities that could exist if they were filing a return containing earned income credit, and we continue to do that today.

Mr. HANCOCK. Well, let me just ask the question. How exactly are you all associated with the Beneficial National Bank?

Mr. BUCKLEY. Beneficial National Bank provides the refund anticipation loans for our offices. For clients requesting refund anticipation loans, those loans go through Beneficial Bank.

Mr. HANCOCK. Do you have any joint ownership or joint board of directors?

Mr. BUCKLEY. No.

Mr. HANCOCK. Thank you, Mrs. Chairman.

Chairman JOHNSON. Thank you and thank both of you for being with us today. I appreciate your comments and your insights, and we hope by the next season that some of these problems will be straightened out and some of your comments will be included. Thank you.

Mr. MARTIN. Thank you for inviting us.

Chairman JOHNSON. The hearing is officially adjourned.

[Whereupon, at 1:49 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

Bank One, Columbus, NA
Columbus Ohio 43271 1021

BANK ONE.

March 3, 1995

The Honorable Nancy L. Johnson, Chair
Subcommittee on Oversight
Committee on Ways and Means
1102 Long Worth House Office Bldg.
Washington, DC 20515

5217

Dear Ms. Johnson:

Bank One, Columbus, is an affiliate of BANC ONE CORPORATION, located in Columbus, Ohio. BANC ONE CORPORATION has assets of $88.9 billion and common equity of $7.3 billion as of December 31, 1994. BANC ONE now operates 65 banks with 1408 offices in Arizona, Colorado, Illinois, Indiana, Kentucky, Ohio, Oklahoma, Texas, Utah, West Virginia, and Wisconsin. BANC ONE also operates several additional corporations that engage in data processing, venture capital, investment and merchant banking, trust, brokerage, investment management, equipment leasing, mortgage banking, consumer finance and insurance.

Bank One, Columbus, is a major stakeholder in the affairs of the Internal Revenue Service (IRS). As such, we appreciate the opportunity to comment on IRS budget issues, 1995 filing season, and thank the Chairman and the committee members for this opportunity to express our views. Bank One is a member of the Council for Electronic Revenue Communications Advancement (CERCA) who has expressed its views to you but we would like to add comments we have as an individual entity. Bank One uses its 1,400 nationwide Banking Centers as collection points for self prepared tax returns to be filed electronically. In 1994, we processed over 25,000 electronic filings. In addition we offer Refund Anticipation Loans (RAL) through some 6,500 independent tax preparers. Over 8 million individual taxpayers have availed themselves of these loans since we began processing in 1989. The total RAL market approaches 20 million taxpayers. Many of these taxpayers come back for our service year after year.

Bank One supports the efforts of the IRS to upgrade the United States tax system through its Tax System Modernization (TSM) program. We are aware of major efforts going back to the 1960's to modernize and integrate the tax system to take full advantage of state-of-the-art technology. Previous IRS efforts that were frustrated have led to the current problems involving fraud, delayed processing, and the set back in the number of electronic filings in 1995. Bank One feels it is imperative that the TSM plan be funded and implemented.

The present filing season is a testament to the problems caused by the IRS's inability to keep pace with technology. The delayed refunds, the abandoned phone calls, and the mountains of paper still to be processed speak volumes as to the changes that are necessary.

The announcement concerning the Direct Deposit Indicator (DDI) on October 26, 1994 was a major blow to electronic filing and TSM. It was ill-timed and unnecessary. Attempting to blame fraud on a legitimate 20 million person RAL market is a sham. Rather than trying to place blame for past errors, we need to go forward together to achieve a safe, secure, and responsive tax system. Proper funding for TSM and for current IRS operations is a vital necessity.

In addition to obtaining TSM technology, the IRS needs to update their stand-alone philosophy. In this age of cyberspace, no entity can stand alone as the IRS is attempting to do. They need to embrace the help that has been offered through organizations such as CERCA and individual stakeholders such as Bank One. We stand ready with commitment and resources to help maintain the most efficient and fair tax system the world has ever known. Please urge the IRS to let its stakeholders help.

Sincerely,

John R. Galvin
Vice President
Bank One, Columbus, NA

cc: Margaret Milner Richardson

STATEMENT OF ROBERT E. BARR, PRESIDENT
COUNCIL FOR ELECTRONIC REVENUE COMMUNICATION ADVANCEMENT

On behalf of the Council for Electronic Revenue Communication Advancement (CERCA), I would like to thank the Chair and the members of this committee for the opportunity to express the Council's views on the IRS budget request and on issues that have arisen to date in the current filing season. CERCA is made up of software producers, telecommunications experts, financial institutions, tax practitioner organizations and others committed to responsibly advancing the use of electronic communications with government revenue agencies. In short, this group has come together to work with the federal government and the individual states on the construction and maintenance of the "tax lane on the information superhighway."

As you can see from the above description, CERCA represents a vertical market segment of the tax industry, from the people who prepare the returns through the companies that empower the preparers with software and the financial institutions that participate in the refund process, to the state and federal agencies to which returns are sent. This unique combination of viewpoints allows CERCA to speak from experience on a great variety of topics in the tax filing process. CERCA would like to take this opportunity to express its support for full funding of the Internal Revenue Service's Tax Systems Modernization (TSM) budget request and to note some concerns regarding the early stages of the current filing season.

Internal Revenue Service Budget Request for Fiscal Year 1996

Of all the items in the Internal Revenue Service budget request, the most critical to the American taxpayer and to the return preparation and filing industries is the Tax Systems Modernization (TSM) program. Last year, this program was budgeted for substantially less than the original IRS request and frankly, this cannot be allowed to continue. The IRS needs these funds to more effectively serve the honest taxpayer and to more efficiently track down the fraudulent tax filer.

TSM will improve service to honest taxpayers by enabling the Internal Revenue Service to answer inquiries in one phone call. The new system will more efficiently handle the volume of incoming calls that flood the IRS on a daily basis. Once their calls have been answered, taxpayers will find that the IRS employees answering the phone are better able to serve them with instant on-line access to information that today takes weeks to gather and forward to Service personnel in the field. This new capability will serve to greatly reduce the number of busy signals that taxpayers receive when calling the IRS, a complaint that seems to arise every year under the current system. Through better routing and access features, the technology will allow the Service to answer more incoming phone calls. By reducing the number of second calls needed, the technology will also serve to reduce the overall volume of incoming calls.

The fraudulent tax filer or tax evader, however, will find this new system substantially tougher to get around. TSM will provide IRS collection employees with the data needed to more effectively search for those failing to comply with the tax laws. The new technology will allow the Service to better target their resources to noncompliant taxpayers, through faster and more accurate matching and a greater access to information about the taxpayer. In addition, the technology will free up considerable numbers of full time employees who currently work on inputting paper returns, allowing these individuals to instead review some of the incoming returns for indicia of fraud . All of this together leads to an increase in the effectiveness of collections, which in turn will increase the amount of taxes collected from those taxpayers who do not voluntarily comply with the Internal Revenue Code. The IRS estimates that for each percentage point increase in voluntary compliance, the Treasury collects an additional seven billion dollars. Assuming that the figure is accurate, the Service could more than pay for this program within a year of its full implementation.

As a final note on tax systems modernization, CERCA would like to address some concerns that have been expressed regarding the Service's progress on TSM relative to the money spent to date. The Council's membership includes many software and systems developers who agree that the costliest period for any system is the planning stage, if it is done correctly. Unfortunately, this stage of the process also produces the least short-term tangible benefits. Systems that are not carefully planned or are rushed into implementation invariably fail to perform the tasks for which they are designed. Cautious progress is an indicator of quality systems design, and reducing the funding for the program as a result would amount to punishing the Service for doing the right thing the right way. While it is difficult now to continue funding of this program when few

tangible results can be shown, it will be far more expensive to spend years fixing a system that was rushed into use.

For these reasons, the Council for Electronic Revenue Communications Advancement respectfully asks the members of this committee to take whatever steps are necessary to ensure the full funding of Tax Systems Modernization as the budget request makes its way through the approval process in the House of Representatives. While this program may seem expensive now, the cost of inaction or inadequate action could be far higher.

Filing Season Concerns

Because CERCA represents such a broad spectrum of what the IRS considers its "stakeholder community," its members have seen several different types of problems with this filing season and the months that led up to it. Beginning with indecision on the direct deposit indicator (DDI) in the fall and moving forward to the current confusion on earned income credit refunds and taxpayer identification issues, the Service has made a great many changes to the filing system that have inconvenienced many taxpayers this season. While CERCA wholeheartedly agrees that the system must be protected from the fraudulent filer, the Council would like to make this subcommittee aware of some of the consequences, intended or otherwise, that have arisen as a result of actions taken to curb fraud. In addition, the Council would like to make several recommendations for legislative or administrative actions which could remedy the current situations.

Direct Deposit Indicator

Since the inception of electronic filing, the Internal Revenue Service has provided an electronic filer with two valuable pieces of information when it receives a return electronically. First, the Service acknowledges acceptance of the return, which tells the taxpayer and the electronic return originator (ERO) that the taxpayer's obligation to file a return has been met. Second, prior to this filing season, the Service provided a direct deposit indicator on claims for refunds filed electronically. The DDI told the ERO that the taxpayer could expect to receive a full refund because no federal obligations existed that would reduce it. This indicator enabled the ERO's who provided refund anticipation loans (RAL's) to show the lending bank that the loan could be made based on the full refund.

For the last two years, rumors have run rampant that the IRS would no longer be providing the DDI. In 1993, the Service announced that it would no longer provide the indicator shortly after April 15. Within a matter of months, the Service had responded to stakeholder concerns and agreed to issue the DDI for the '94 filing season. These rumors arose again in 1994 out of concern that the IRS had associated the DDI with the filing of fraudulent returns.

On October 6, 1994, Under Secretary of the Treasury Ronald Noble stated before this very subcommittee that in fact the DDI should remain in place for the '95 filing season. While expressing some concern that the speed with which refunds were provided to electronic filers might limit the Service's ability to properly review the claims, the task force which the Under Secretary headed could not find a direct link between provision of a RAL and the filing of fraudulent returns. In fact, the task force reported that, "[T]he DDI may offer some potential for increased fraud control and for increased ELF filing by genuine taxpayers." Mr. Noble went on to state before this committee that the DDI should be studied during the 1995 filing season in order to weigh its benefits against its potential for facilitating fraudulent refund claims.

This position led to the formulation of plans for the '95 filing season based on the availability of the DDI. Advertising campaigns were planned, financial institutions prepared for the influx of the loan applications, approximately 25,000 practitioners readied themselves to provide the RAL service to clients and millions of taxpayers prepared to receive RAL's

Within three weeks, then-Secretary of the Treasury Lloyd Bentsen announced that the DDI would not be available for the 1995 filing season, stating that "a very high number of EITC fraud schemes involve refund anticipation loans, and those loans are based on the direct deposit indicator." As a result, two of the four financial institutions that previously made refund anticipation loans refused to provide the Service this year. The top price of a RAL rose from $34

in 1994 to $89 in 1995. This means that the taxpayers who need their refund most of all will now be receiving less of the money they are due.

The circumstances surrounding the DDI and the 1995 filing season have led CERCA to respectfully make the following two recommendations to this committee. First, set a published date after which no significant changes could be made to the rules affecting the upcoming tax filing season. Such a date would give stakeholders the ability to make definite plans after that date. For instance, had this restriction been November 1, 1994, the Treasury Department could still have changed its position after testifying before this committee and those affected this year would have been on notice that nothing was final until November 1. Such a notice might have saved many stakeholders considerable inconvenience and expense this year. CERCA would prefer a much earlier date, however.

Second, until someone proves the allegations of fraud associated with the RAL, CERCA asks that the direct deposit indicator be reinstated in order to limit the cost of the refund anticipation loan to the taxpayer. Under Secretary Noble never stated that the Treasury's Task Force on Refund Fraud found conclusive evidence to determine whether the loans were a cause of fraud. He recommended further study before taking action on the issue. Under the current circumstances, the IRS is taking halting regulatory steps which are slowly strangling the RAL providers out of the business.

CERCA asks that the study recommended by Under Secretary Noble be conducted during the 1996 filing season. If the RAL is causing fraud, we ask that the industry be given at least one filing season to work with the Internal Revenue Service to correct the problem. If further study shows that the steps taken to correct the problem have failed, we would support action by this subcommittee to eliminate the program completely.

Earned Income Credit Split Payments

Another step taken by the IRS to stem the tide of fraudulent refunds in the 1995 filing season has been the bifurcation of earned income credit refund payments. Many taxpayers qualifying for the credit, particularly those filing as either head of household or single, have found that the Service will provide that portion of their payment which represents the refund of withheld taxes within the normal time period and in the form requested. However, the earned income credit portion of the refund is being held back for eight to ten weeks on as many as seven million returns. This action is necessary to allow the Service to more closely examine the taxpayer's claim. The difficulty arises with the fact that, once authorized, the earned income credit is mailed directly to the taxpayer in the form of a check. This has caused three problems for affected taxpayers.

First, it holds the money that Congress has designated for low income taxpayers out of the hands of those taxpayers for an inordinate amount of time. No one argues with the need for the Service to secure the system, but we are talking about money upon which America's neediest taxpayers have come to rely. Currently, the delay is eight to ten weeks. As the filing season progresses and the Service becomes increasingly busy, who is to say how long it will take to turn the earned income credit refunds around? Something must be done to speed up the process. In the future, full funding of tax systems modernization will make this process much faster and much more responsive to taxpayer needs. For this year, however, faster response on questionable earned income credits will probably require an increased manpower commitment from the IRS.

Second, the current system partially eliminates the direct deposit option for affected taxpayers. We are not talking about the direct deposit indicator now, but simply the option to have your refund deposited directly into your account. Keep in mind that this affects America's poorest taxpayers, individuals for whom the direct deposit represents a secure way to receive a refund, as opposed to simply a convenience. Many taxpayers who receive the earned income credit live in neighborhoods where theft of government checks from mailboxes is a common occurrence and where getting a check to the bank can be a risky venture. These individuals count on direct deposit to avoid the necessity of carrying a substantial check to the bank and making a deposit in person.

Third, it creates an often unforeseen financial obligation on taxpayers who receive refund

anticipation loans. These individuals receive their RAL based on the full amount of the refund which the bank believes will be deposited into the taxpayer's account. When the check for the earned income credit goes to the taxpayer, it creates an obligation on the part of the taxpayer to return the money to the RAL lenders. Those who receive the checks often believe that, since it comes from the government, it must be free of encumbrance. Many never bother to contact the ERO who filed the return to find out exactly what has happened. When this obligation goes unpaid, it eventually winds up on a credit report and comes back to haunt the taxpayer at a future time.

In response to these concerns, CERCA respectfully recommends that action be taken to ensure that once a taxpayer qualifies for and requests a direct deposit, the entire refund is deposited directly to the taxpayer's account. If the Service needs extra time to examine claims for the earned income credit, a bifurcated payment system should certainly be allowed. However, the taxpayer's request for a direct deposit should be honored for both segments of the payment.

Social Security Number Scrutiny

The last concern that has arisen out of this tax season is the closer scrutiny of social security numbers by the Internal Revenue Service. Clearly, this increased emphasis on accuracy is a vital part of the efforts to stop the flow of fraudulent refunds out of the Treasury. Nevertheless, some concerns have arisen with the coordination between the Internal Revenue Service and the Social Security database used to verify taxpayer numbers. CERCA would like to request that the communications process between these two agencies should be reviewed in order to determine what measures can be taken to more effectively and efficiently match taxpayer names and social security numbers.

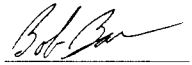
Constructive Congressional Relationship Needed

Finally, CERCA would like to respectfully recommend that this committee take a proactive stance toward the Internal Revenue Service, working to head off difficulties before they grow into nationwide problems. In addition, we would like to offer the Council for Electronic Revenue Communication Advancement as a resource for you in your work with the IRS to make sure that the tax system runs at maximum efficiency and effectiveness. CERCA was created at the behest of the Internal Revenue Service to provide a sounding board that represented every facet of the tax preparation and filing industries. Due to the breadth of its membership, CERCA can provide detailed information on almost any function in the process of filing a return.

Conclusion

In closing, we would like to thank this honorable committee for the opportunity to submit this written statement and we hope that you will consider the Council for Electronic Revenue Communication Advancement as a valuable source of information in your work to improve the administration of the tax system.

Respectfully submitted



Robert E. Barr
President
Council for Electronic Revenue
Communication Advancement

STATEMENT OF WILLIAM STEVENSON, CHAIRMAN OF FEDERAL TAXATION NATIONAL SOCIETY OF PUBLIC ACCOUNTANTS

On behalf of the 20,000 members of the National Society of Public Accountants (NSPA) and the 5 million small businesses and individuals they serve, I would like to thank the Chair and the members of this Subcommittee for the opportunity to express the Society's views on the IRS budget request and on issues that have arisen to date in the current filing season. NSPA's members, individuals providing a variety of accounting and tax services to small businesses and individuals throughout the nation, would like to express their support for the Service's Tax Systems Modernization (TSM) program. The Society would also like to take this opportunity to inform this Subcommittee of several concerns that have arisen as a result of fraud initiatives taken by the Internal Revenue Service this filing season.

Tax Systems Modernization

Of all the items in the IRS budget, TSM is the one program that has the potential to pay exponential dividends for the federal government. While the remainder of the Service's budget request focuses on increasing productivity by increasing staff and resources spent on production in the current system, TSM requests funding for computer systems that will empower Service employees to produce at levels far beyond their current output. The new system, once in place, will greatly improve the Service's ability to administer the tax system, to apprehend fraudulent taxpayers and to serve honest taxpayers.

The Internal Revenue Service needs Tax Systems Modernization because, once implemented, it will greatly reduce the cost of administering the tax system. Processing of returns will be more efficient with the addition of new technologies in optical scanning of paper returns as well as the transmission of electronically filed returns. Examinations will be more effective when the examiners have ready access to prior year returns at the push of a button on their portable computers. Returns and refunds will be more carefully and quickly scrutinized by improved document matching systems, allowing the Service to process legitimate refunds in less time and to identify questionable refunds before fraudulent filers have a chance to take the government's money and run. Finally, TSM will allow the IRS to effectively add much more than the 888 employees they have requested this year, as those employees who currently spend their days processing paper and inputting data can be retrained to spend their time scrutinizing returns for key signs of fraud.

Fraudulent filers would be the first to notice the Service's improved capabilities, as the increasingly effective computer analysis and the increased level of human analysis will weed out more and more of the fraudulent returns that rob the Treasury of an estimated $5 billion annually. Today, the Service is charged with using a vintage 1960's computer system to track down sophisticated tax avoidance schemes born of 1990's technology. With modern technology, the Service could better process and analyze all of the information returns that it receives, a key element in finding fraudulent filers. For every one percentage point increase in voluntary compliance levels, the Department of Treasury estimates that an additional $7 billion dollars in revenue is collected. Given that estimate, this system could pay for its 1996 budget estimate more than five times over by simply raising the compliance level by one point. Given that it has the potential to increase voluntary compliance by far more than one percentage point, TSM represents a great investment in stopping the fraudulent filer and collecting the proper amount of taxes owed to the Treasury.

Aside from the benefit that honest taxpayers receive when fraudulent filers and tax avoiders are brought into compliance, the honest taxpayer will also find a much more responsive Internal Revenue Service once TSM has been fully implemented. The IRS is the only government agency that, by law, all American taxpayers must contact every year. As such, the method in which the IRS provides service to the taxpayer will often form a taxpayer's opinion of the federal government as a whole. Under the current system, Congress hears annually from the General Accounting Office (GAO) about how the Service is unable to effectively answer its telephones and that those taxpayers lucky enough to get through once often find that it takes several calls to resolve their problems.

TSM offers an effective remedy to this currently unacceptable state of affairs first by empowering the Service to answer more telephones and second by enabling Service employees answering those phones to resolve taxpayer issues in only one call. Effective routing of calls

to the proper desk within the Service will provide taxpayers with better information on the first call. Making taxpayer information available via computer to the person answering the telephone will provide Service employees with the ability to resolve the question during the course of the first call, rather than having to request paper copies of returns from central filing locations and waiting weeks to receive them.

Because TSM will mean a more efficient Internal Revenue Service, better able to catch the fraudulent filer and the tax evader and better able to serve the honest taxpayer, NSPA respectfully requests that this Subcommittee take whatever steps possible to support the Service's request as the budget process continues over the next few months.

Current Filing Season Concerns

The Internal Revenue Service has gone to great lengths this year to curb refund fraud and the tireless efforts of the individuals charged with developing new safeguards are to be commended. However, NSPA would like to bring to light several concerns that have arisen with these safeguards and with unintended consequences that may affect honest taxpayers and practitioners as well as those that the safeguards were designed to apprehend. These concerns center first around procedures that the Service has implemented which place additional burdens on practitioners during busy season and second around steps that the Service could take to more effectively communicate some of the nonconfidential aspects of the revisions made to the return filing system this year.

Practitioner Concerns

NSPA recognizes that some of the fraud problems that have come to light in recent years have been caused by unscrupulous practitioners exploiting weaknesses in the tax system that they may have discovered in the course of their practices. Nevertheless, the Society's members have expressed a growing concern that the Service's efforts to stop fraudulent practitioners are increasingly hampering the ability of honest practitioners to conduct their practices during busy season. The clearest example of this problem is a procedure known as an "electronic filing compliance check," under which a practitioner who has been accepted to transmit returns electronically to the Service is examined for compliance with the rules governing electronic filing detailed in Revenue Procedure 94-63.

Ideally in an electronic filing (ELF) compliance check, Service personnel will come into a practitioners office, review the signature documents and W-2 forms which the practitioner is required to keep on file, briefly review security measures regarding the use of the electronic filing identification number (EFIN) and leave the practitioner's office in a relatively short period of time. This year the Service has taken several steps toward improving this practice, most notably scheduling appointments with practitioners where no suspicion of criminal activity exists, as opposed to last year's practice of performing all of these visits unannounced.

Two remaining steps are needed in order to make this program fair to the practitioners who are forced to undergo these checks. The Internal Revenue Service needs to publish a clear list of the documents that an agent is allowed to request in these checks and establish a time limit after which Service personnel should have to show reasonable cause for continuing the check. It is only fair that a practitioner undergoing an exam of this nature should be told what he or she is expected to produce and the amount of time allowed for the exam under normal circumstances. If the exam shows signs of fraud that require deeper investigation, a practitioner should be informed of the problem before the exam extends past the designated time.

NSPA does not dispute the Service's right to perform these checks and the Society acknowledges the need to perform them unannounced in certain circumstances. What we need the Service to understand is that practitioners are already swamped at this time of year and the intrusion must be kept to a minimum. If the IRS agents performing these exams have a specific checklist of what to look for and the practitioners know what to produce, these procedures don't need to take more than a few moments. Instead, different Service personnel ask for different documents and some practitioners lose substantial amounts of time to these exams at a time of year when they can least afford it. We ask for this Subcommittee's

assistance in working with the Internal Revenue Service to develop a reasonable regulation that will solve this problem.

Communications Issues

The problems that have arisen this year as a result of poor communications regarding the new steps that the IRS has taken to stop refund fraud are best explained by looking first at an example of how well the Service can communicate on these issues when it has the time and the resources. This year, as part of its efforts to control refund fraud, the IRS placed new restrictions on electronic return originators (ERO's), the practitioners who register to transmit returns electronically to the Service. New applicants would have to go through a substantial review process and even those renewing prior year's applications could find themselves submitting substantially more information. The new rules would affect many practitioners and getting the information out to them was of critical importance both to the IRS and to organizations like NSPA.

The day before the IRS made its formal announcement of the new rules, a meeting was held with practitioner organizations in Washington, DC. The Service released to the organizations advance copies of the Revenue Procedure describing the application process and the background check requirements. Several top level IRS staffers familiar with the program made themselves available to answer any questions that arose either at the meeting or later. This outreach effort was successful because it enabled the associations to carry accurate information to our members almost before they heard it anywhere else and it empowered the groups to accurately answer the question of those members who had heard bits and pieces of information elsewhere. It recognized the fact that on many key issues, the IRS and the practitioner community are in fact partners in the administration of the tax system.

Unfortunately, this level of communication on the new fraud control programs this year did not continue. Since the introduction of the new ERO rules, three examples of inadequate communication between the Service and the practitioner community have arisen that clearly demonstrate the importance of this partnership.

One new tool implemented this year was the 1040-V voucher form, designed to help the Service better track payments for balance-due returns filed electronically and for other specialized types of individual returns. The Service has also run several experimental programs in different districts aimed at more efficiently processing payments, including providing different addresses to which taxpayers can mail their return depending on whether they are getting a refund or paying a balance due. The Service did not adequately publicize these programs before filing season began, though, and groups like NSPA have fielded a considerable number of questions from confused practitioners who, after many years in the business, find themselves in the embarrassing position of not knowing where to send their clients' returns.

As a result, the IRS released on February 7 a "Practitioner Alert" attempting to clear up the confusion caused by the new procedures. While the release did answer the questions of most practitioners, the timing makes the release less than fully effective. Many practitioners, even at the beginning of February, are so immersed in tax preparation that few outside sources of information reach them effectively. In order to effectively support these IRS tests, the practitioner community must be brought into the loop much earlier in the development of the new procedures.

Another new procedure that the IRS put into use this year to control fraudulent claims for the earned income tax credit (EITC) is a split payment of refunds that include a questionable claim for the credit. This extra time allows the Service to perform more detailed checks on these questionable claims while still refunding withheld taxes to the taxpayer as quickly as possible. While these new checks will undoubtedly save the Treasury from paying out fraudulent claims, inadequate communication regarding the process has led to considerable confusion among the taxpaying public and the practitioner community.

The Society would like to make perfectly clear that we do not question the right of the Service

to perform these additional checks. In fact, we wholeheartedly support the IRS in these critical efforts. We ask only that the Service recognize the role that the tax practitioner plays as a liaison between the taxpayer and the tax system. By informing practitioners early about these new procedures, practitioners can in turn inform their clients and improve their understanding of the filing process. When practitioners are left to find out over the course of filing season what changes are affecting their clients, taxpayers are left feeling victimized by a system that they cannot understand.

Finally, the National Society would like to address the very sensitive issue of matching social security numbers. In this case, it really seemed as though the system was working. As early as last June, Commissioner Richardson made clear to everyone involved with the system that social security numbers should be double-checked by practitioners. NSPA reminded its members no fewer than four times throughout last summer and this fall through newsletter articles.

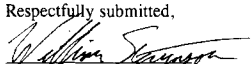
Nevertheless, the severity of the checks has surprised the preparer community this year. Electronically filed returns that were accepted without question last year are being rejected this year because, among other reasons, middle initials are missing and because married individuals who have filed jointly for years are finding that the Service has no record of a name change after their wedding. These screens are currently causing problems primarily for electronically filed returns, since those returns are typically filed early in the season and the taxpayer finds out more quickly that the return has been rejected. Once the paper filing season picks up, it appears likely that these new procedures will substantially slow the processing of those returns as well. Practitioners are now being forced away from using the mailing label which the IRS provides the taxpayer, an important tool for IRS processing. Under the current system, the information on that label could fail to match the social security numbers on file for the individual, due to missing middle initials, married names and other similar circumstances. In order to protect clients from these potential pitfalls, practitioners are mailing the returns with taxpayer names and identification numbers printed by computer onto the form.

In closing, NSPA would like to note that the Internal Revenue Service has gone to great lengths this year to comply with the mandate from this Subcommittee that the flow of fraudulent refund money out of the Treasury be stopped. Nothing in this statement is intended to imply that the steps taken by the Service are improper or unwarranted, although in the case of social security matching, the Society would submit that the system could have been more taxpayer friendly. The members of NSPA would like to point out, however, that these critical steps could have been more effective for the IRS and less burdensome to taxpayers and tax practitioners around the country if the Service had been more forthcoming with details.

Throughout the fall, NSPA was told by key Service personnel that, "If we tell you everything we are doing to protect the tax system, we cannot effectively protect the tax system." While that statement is true to some extent, the Society respectfully submits that if the IRS does not tell tax practitioners what it is doing to administer the tax system, the Service will hinder its ability to effectively administer the tax system. We ask this Subcommittee to take an active role in making sure that this critical information reaches practitioners and taxpayers in a more timely manner in the future.

On behalf of the National Society of Public Accountants, I would like to thank Madam Chair for providing us with the opportunity to submit comments on these topics which are so critical to our members. NSPA wishes you success in your efforts toward overseeing the tax system, and we hope that you will consider the Society as a valuable resource in support of those efforts.

Respectfully submitted,



Dr. William Stevenson
Chairman of Federal Taxation
National Society of Public Accountants

STATEMENT OF STEVE J. SAFIGAN, PRESIDENT UNIVERSAL TAX SYSTEMS, INC.

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The attached statement responds to certain comments made by IRS Deputy Commissioner Michael Dolan during The House Ways and Means Oversight Committee hearing on Monday, February 27, 1995 convened to address Tax Systems Modernization and the 1995 tax filing season. More particularly, Mr. Dolan's comment that there is "statistically valid" data showing the DDI to be material in causing fraud contradicts the findings of the Task Force appointed by the Treasury Department that addressed the DDI under the direction of Under Secretary of the Treasury Ron Noble.

During Mr. Noble's testimony to this Subcommittee on October 6, 1994 as to whether the IRS should abolish the DDI, he stated that The Department of the Treasury was not concerned that the DDI would cause fraud losses to the IRS. Rather, he testified that the DDI could play a role in improving fraud detection and that banks offering refund anticipation loans, rather than the IRS, would be at risk of loss. Mr. Noble also stated that now was not the time to remove the DDI, but rather the impact of the DDI should be continued to be examined during the 1995 filing season.

Despite the above findings, on October 26, 1994 Secretary of the Treasury Lloyd Bentsen announced the elimination of the DDI.

The actions taken during the current filing season regarding the DDI have simply not accomplished the same nor acceptable goals as communicated by the IRS. Nor does the current preemptive EITC withholding program attempt to prevent innocent and honest taxpayers from being unnecessarily and negatively affected.

I would like to thank the Chairman and the members of this Subcommittee for the opportunity to express our views. We are Universal Tax Systems, Inc., a developer of tax preparation software and a third-party transmitter of electronic returns. Last year our software was used to transmit well over one million tax returns electronically to the IRS and 30 state revenue departments. Our software was also used at hundreds of IRS VITA sites, district offices, service centers, and military installations here and abroad. We also file electronically for home users of tax software packages designed for individuals who do not use a preparer. We are in our second year of involvement in the IRS File-from-Home initiative. Our president, Steve Safigan, serves as the Vice-President, Infrastructure for the Council for Electronic Revenue Communication Advancement (CERCA) and is an active member of the Electronic Filing Committee of the National Association of Computerized Tax Processors (NACTP).

We wish to express alarm at some of the statements made by Deputy Commissioner Michael Dolan when questioned by Chairman Johnson about the Direct Deposit Indicator (DDI). If you recall, Mr. Dolan attempted to defend the IRS' decision to retain the DDI during the 1994 processing season, but removed it for the 1995 processing season.

Mr. Dolan claimed that there was "statistically valid" data showing that the DDI indeed caused fraud, and that the data was collected during the 1994 processing season. This was the reason, he claimed, for the decision to remove the DDI. His testimony contradicts the Treasury Department's own findings. As you know, this very Subcommittee directed then-Secretary of the Treasury Lloyd Bentsen to commission a task force to examine refund fraud and to make recommendations. The task force was convened under the direction of Under Secretary Ron Noble. Mr. Noble reported his findings in thoughtful and well-informed testimony to this Subcommittee on October 6, 1994.

Mr. Noble devoted 3 pages of his testimony to the question, "Should the IRS abolish the DDI?" His testimony can be summarized as follows.

> The Task Force found two grounds for concern about the DDI: cost and speed... if the IRS is to continue the DDI, the RAL banks that benefit from it should pay the administrative costs of the DDI check. Were they to do so, the cost concern would not be a major one. With regard to the second issue the speed with which electronic refunds can be delivered, our concern is <u>not</u> that the DDI will cause the IRS to suffer fraud losses. If the IRS pays no refunds until it receives all of the paperwork that must accompany an ELF return and until all of the detection procedures currently planned for the 1995 and subsequent filing seasons have been undertaken, the issuance of a DDI should neither increase nor decrease the likelihood that the IRS will be the victim of ELF fraud. As long as the IRS will run necessary checks on all electronic returns, all will be screened equally without regard to whether a DDI has been issued...the irony is that the speed of the DDI and RAL loans may lead in a relatively short time to improved fraud detection. This irony is attributable to the fact that, if the IRS detects problematic returns and stops refunds, the banks rather than the IRS will be at risk of loss... Thus, the Task Force believes that the DDI may offer some potential for <u>increased</u> fraud control and for increased ELF filing by genuine taxpayers... Accordingly, the Task Force concludes that this is not the time for a firm recommendation either to continue the DDI indefinitely or to kill it immediately. In lieu of either of these extremes, the Task Force believes that Treasury and the IRS should continue to examine the impact of the DDI on electronic filing in the next filing season and to determine what effects it has on fraud control and on incentives for ELF filing.

Twenty days later, on October 26, 1994, then-Secretary of the Treasury Bentsen announced the elimination of the DDI. Mr. Noble and Commissioner Richardson were in attendance. In light of subsequent actions, Mr. Noble might well regret the candor he displayed in his testimony before this Subcommittee.

Unbiased examination of the record would indicate that one of the following must be true: a) no "statistically valid" research exists showing such compelling evidence as Mr. Dolan testified; b) this research was withheld from Mr. Noble's task force; or c) the Task Force reviewed the research and considered it not worth mentioning.

Our conclusion is that the IRS is attempting to strangle the RAL banks out of business by exposing them to unacceptable risk. This strategy encourages tax cheats, deadbeat parents, and other federal debtors to defraud the banks using the U.S. Tax System. The removal of the DDI was only partially successful at eliminating refund loans. The IRS then instituted its EITC withholding program, which delayed payment to millions of eligible EITC recipients. Our examination of this program indicates that the IRS' initial screening criteria consisted primarily of two filters: a) the taxpayer claimed EITC, and b) the amount of the EITC was above a certain dollar threshold. This is hardly a program designed to assure that the honest claimant receives the EITC he/she deserves. More importantly to the financial institutions, the delayed payment was not directed into the taxpayer's account at the RAL bank, as the taxpayer requested.

Private industry knows well what's at stake if the fraud issue is not dealt with decisively. The sad fact, to quote Mr. Noble, is that "EROs and ERTs have the potential to serve as eyes and ears in the problematic refund prevention and detection effort." Instead, the IRS has chosen to demonize the financial institutions and more than 25,000 EROs who offer RALs to clients who appreciate the service. Our experience would indicate that the IRS' Social Security Number verification program is the only fraud prevention measure which was worth its expense and impact. The SSN verification program was tremendously effective in driving most fraud from the system. We certainly believe the IRS has the right to delay any suspicious refunds, so long as the IRS has legitimate reason to suspect that each return is problematic, the public is informed of any severe or widespread impact, and the taxpayer's original instructions are followed concerning where the refund is directed.

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EXPLORING THE DEVELOPMENT OF TAXPAYER BILL OF RIGHTS II LEGISLATION

HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

OF THE

COMMITTEE ON WAYS AND MEANS

HOUSE OF REPRESENTATIVES

ONE HUNDRED FOURTH CONGRESS

FIRST SESSION

MARCH 24, 1995

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EXPLORING THE DEVELOPMENT OF TAXPAYER BILL OF RIGHTS II LEGISLATION

FRIDAY, MARCH 24, 1995

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT,
Washington, DC.

The subcommittee met, pursuant to call, at 9:10 a.m., in room 1100, Longworth House Office Building, Hon. Nancy L. Johnson (chairman of the subcommittee) presiding.

[The press release announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON OVERSIGHT

FOR IMMEDIATE RELEASE
March 14, 1995
No. OV-4

CONTACT: (202) 225-7601

JOHNSON ANNOUNCES HEARING TO EXPLORE THE DEVELOPMENT OF TAXPAYER BILL OF RIGHTS II LEGISLATION

Congresswoman Nancy L. Johnson (R-CT), Chairman of the Subcommittee on Oversight of the Committee on Ways and Means, today announced that the Subcommittee will conduct a hearing to explore the development of Taxpayer Bill of Rights II legislation during the 104th Congress. **The hearing will be held on Friday, March 24, 1995, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 9:00 a.m.**

This hearing will feature invited witnesses only. In view of the limited time available to hear witnesses, the Subcommittee will not be able to accommodate requests to testify other than from those who are invited. Those persons and organizations not scheduled for an oral appearance are welcome to submit written statements for the record of the hearing.

BACKGROUND:

The term "Taxpayer Bill of Rights" refers to legislation that combines numerous individual provisions to strengthen the rights of taxpayers in their dealings with the Internal Revenue Service (IRS). The original Taxpayer Bill of Rights (TBR) became law in 1988. It sought to create a more level playing field between taxpayers and the IRS by creating over one dozen procedural safeguards for taxpayers. For example, it gave taxpayers a legal right to sue the IRS for up to $100,000 in damages in order to redress reckless actions taken by IRS agents in collecting taxes. It gave taxpayers in financial difficulty the statutory right to pursue installment payments plans with the IRS. It also prohibited the IRS from evaluating collection agents based on their collection results and from imposing collection quotas on its agents. Finally, it gave taxpayers who prevail over the IRS in litigation the right to have the IRS reimburse part of their attorney fees in some circumstances.

The 1988 legislation was a step in the right direction, but the general consensus was that much more could be done to help taxpayers. The Oversight Subcommittee held two days of hearings in 1991 to explore legislation to build on the 1988 TBR and further improve taxpayer safeguards and rights in dealing with the IRS. This hearing activity led the Subcommittee to conclude that it would be desirable to pursue a Taxpayer Bill of Rights II (TBR2). The Subcommittee Members developed H.R 3838 as legislation to create the taxpayer safeguards that they had identified as being helpful to taxpayers. H.R 3838 was introduced in November, 1991. A modified version of H.R. 3838 was included in H.R. 11, the Revenue Act of 1992, which passed Congress in October 1992, but was vetoed by President Bush for reasons unrelated to the TBR2 provisions.

The TBR2 provisions in H.R. 11 contained over two dozen provisions to help taxpayers. For example, one provision would have expanded the power of the Taxpayer Ombudsman in the IRS to issue protective orders to help taxpayers who were being treated unfairly by the application of normal IRS procedures. It would have imposed on the IRS an obligation to take reasonable steps to corroborate information returns whose accuracy is

disputed by the taxpayer. It would have given the IRS the authority to waive the interest on late tax payments in cases where the taxpayer had a good reason for the late payment. (Under current law, the IRS has broad authority to waive penalties but not the interest on late tax payments.) It also would have required the IRS to give that taxpayer 30 days advance notice before it revoked an installment payment agreement that it previously had entered into with a taxpayer.

The need for a Taxpayer Bill of Rights II has not diminished since 1992. Taxpayers would benefit if their rights were strengthened in dealing with the IRS. A good starting point in exploring expansions of the Taxpayer Bill of Rights in the 104th Congress would be the provisions that passed Congress in 1992 as part of H.R. 11. In addition, other legislation has been introduced in the 104th Congress, which builds on the earlier TBR.

In announcing the hearing, Chairman Johnson said: "When the average taxpayer goes up against the IRS, it's like a contest between David and Goliath. We should investigate ways to safeguard the rights of taxpayers in these contests. Taxpayers have a duty to pay their lawful tax liability, but they should not be put at a disadvantage by procedural rules and IRS policies that make the David and Goliath contest any more one-sided than it often is."

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Any person or organization wishing to submit a written statement for the printed record of the hearing should submit at least six (6) copies of their statement by the close of business, Monday, April 3, 1995 to Phillip D. Moseley, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements wish to have their statements distributed to the press and interested public at the hearing, they may deliver 200 additional copies for this purpose to the Subcommittee on Oversight office, room 1136 Longworth House Office Building, at least one hour before the hearing begins.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages including attachments.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. A witness appearing at a public hearing, or submitting a statement for the record of a public hearing, or submitting written comments in response to a published request for comments by the Committee, must include on his statement or submission a list of all clients, persons, or organizations on whose behalf the witness appears.

4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and the public during the course of a public hearing may be submitted in other forms.

Note: All Committee advisories and news releases are now available over the Internet at GOPHER.HOUSE.GOV, under 'HOUSE COMMITTEE INFORMATION'.

*****

Chairman JOHNSON. Good morning, ladies and gentlemen. I welcome you to our hearing to explore the development of a Taxpayer Bill of Rights II in the 104th Congress.

The primary mission of the IRS is enforcing our Nation's tax laws and collecting taxes that are legally owed. They collect $1 trillion in taxes a year. They struggle with $150 billion that people don't voluntarily offer with an outmoded computer system and 114,000 employees. On the whole, they do an outstanding job, but as with any big organization that has to do something that not everybody thinks is fun, they have some hard times and can be heavy-handed.

In the past, we have written Taxpayer Bill of Rights legislation. In 1988, we adopted a dozen procedural safeguards for taxpayers. We allowed taxpayers to make installment payments under certain circumstances and also gave taxpayers who prevail over the IRS the right to have the IRS reimburse their attorneys' fees in certain circumstances.

In the early 1990's, we gave a lot of time and attention to trying to assure that the playing field between the Government and its people on tax issues was relatively level. Unfortunately, that legislation, while it was broadly supported by the committee and was included in H.R. 11, was in the end vetoed by President Bush for unrelated reasons.

We now return to the issue of a Taxpayer Bill of Rights, and it is my intention and that of my committee to consider the provisions that we looked at in the early 1990's and to listen to our colleagues and listen to the people out there to see what measures are appropriate at this time to assure that in this period when, frankly, the IRS is faced with enforcing a far more complex code than a few years ago and a higher level of willingness on the part of people to deceive and dissemble in regard to their tax obligations and, therefore, has required the Government to have a far more aggressive antifraud program, that in this setting we also deal with the problems that intrusion and the disparity between the resources of the Government and particularly small individual taxpayers is properly balanced and that citizens in America don't feel unnecessarily powerless and defenseless in the face of the Government. Yet the Government must have the tools and position it needs to assure compliance with our Tax Code and with the obligations each citizen assumes to support the services of Government.

I yield now to my colleague, Mr. Matsui, the ranking member of the Oversight Subcommittee.

Mr. MATSUI. Thank you very much, Chairwoman Johnson. I first of all want to thank you for holding these very, very valuable hearings. I think, obviously, the fact that you have taken such a strong leadership role in this will mean that we will undoubtedly this year have legislation prepared, and I really appreciate the fact that you are moving in that direction. So I want to thank you very personally.

Second, very briefly, I think you gave an important and strong statement about what these hearings and future legislation are all about. But I might just add that, as you stated, we want balance in the collection of revenues to the Federal Government. Certainly, the Internal Revenue Service, which has a great deal of power and

influence over American society, must understand that taxpayers do have some rights and remedies. And so the issue of balance is very critical.

At the same time, I would hope that the Service and its valuable employees understands that this is not meant to cast aspersions upon the Internal Revenue Service itself. There are many tools, for example, that the Service does not have that I am sure it would like to have. It cannot waive penalties when the Service, for whatever reason, is not able to process a taxpayer's claim. Oftentimes, liens are misfiled. The Service does not have the ability to lift those liens. And so there are many valuable tools that we need to give the Service in order to have the Service do its proper work.

So I would not want the Service to view this as a threat, but to view this as a process in which all of us are working together to provide the best service possible to the American taxpayer.

So, again, I want to thank you very much for holding these hearings, and I look forward to the witnesses and certainly the markup of the legislation when it becomes available.

Chairman JOHNSON. Would any other member of the committee care to make a comment?

[No response.]

Chairman JOHNSON. We are pleased to welcome the Honorable Senator Grassley of Iowa as our first witness.

Senator Grassley, you have done a lot of work in this area yourself. We are pleased to have you here this morning, and we look forward to working with you on legislation that we hope not only will be considered by the House and the Senate, but let me make this point at this time since I rarely have a chance to say this directly to an esteemed Member of the other body.

I would hope that as we move this legislation forward that it could go to the floor separately and independently and not part of a whole great big bill. I think it is important in this era of public discouragement, in a sense, with the Congress that we move bills succinctly and independently so people can see exactly what we are doing. In this case, it is so important that people see that we are trying to balance their rights against their Government's at the same time we preserve the power of their Government to do what is in the public interest. For them to be able to see that legislation and hear that debate I think is important, and I hope to move this as an independent bill forward. And I would hope that it would be able to have that same treatment in the Senate.

STATEMENT OF HON. CHARLES E. GRASSLEY, A U.S. SENATOR FROM THE STATE OF IOWA

Senator GRASSLEY. Let me suggest to you that that rarely happens. It is a very legitimate request and one that I would not shy away from. The process in the Senate doesn't lend itself very often to that happening, and I am sure to the chagrin of Members of this very important body, who have the constitutional responsibility of initiating such legislation as tax legislation.

Well, I, too, thank you very much for your interest in this very important issue and an opportunity to be with you. Thank you very much for holding this hearing.

As many taxpayers are struggling in the midst of the current tax-filing season, then obviously the issue of taxpayers' rights takes on kind of a very special importance. Although most IRS employees provide very valuable and very responsible service, taxpayer abuse by the Government is, of course, an ongoing problem. So with this in mind, I am very happy to have joined Senator Pryor and others in reintroducing the Taxpayer Bill of Rights II in the Senate as S. 258. This is a very necessary legislation, and it happens to build upon the original Taxpayer Bill of Rights that we passed into law in 1988.

Now, for me, the long process of trying to ensure taxpayer protections began in the early 1980's. At that time I was a member and then chairman of the Finance Subcommittee on IRS oversight. We made some progress, but it was only the beginning. Senator Pryor helped continue the cause when he succeeded me as chairman in 1987. At that time, we took the initiative and he asked me to work with him in pushing for a Taxpayer Bill of Rights by expanding legislation I and others had introduced. It took nearly 2 years, but we ultimately succeeded in achieving this goal and the passage of the Taxpayer Bill of Rights.

We now have a 6-year record of implementing the legislation, and specifically as it regards the Taxpayer Bill of Rights. Great strides toward taxpayer protection were achieved through this important piece of legislation. Now, however, the Taxpayer Bill of Rights of 1988 was never then, nor now, expected to be the final chapter in the book of taxpayer protection. It was a very major step in the continuing process of stamping out taxpayer abuse, and that process still continues to this very day as we look into new and different ways to improve the current law.

In reviewing the record, it is clear that much more needs to be done. There is no question that breakdowns in implementing the law have occurred, and there are gaps in the law that need to be filled.

For instance, we believe that the current ombudsman position is too limited and too beholden to IRS insiders. Our legislation will turn the ombudsman into a more independent office of taxpayer advocacy. And the purpose of that office is to expand powers for that office to help taxpayers and for the office director to have direct control in the hiring and firing of problem resolution officers. Currently, these officers are too beholden to their respective district directors and tax collection officers.

Other important provisions include the abatement of interest with respect to unreasonable errors or delays by the IRS. We also create a cause of action against the IRS for wrongful liens. In addition, taxpayers would have a right to an installment agreement for liabilities of less than $10,000.

We were successful in passing a similar proposal through the Congress in 1992. However, the underlying legislation at that time, because it was attached to a proposal, was vetoed by former President Bush. So, of course, we are back again in this new Congress to attempt to do as well or even better than we did in 1992.

Since 1987, Senator Pryor and I have worked in a cooperative, bipartisan effort to further taxpayers' rights. As our roles change somewhat in this new Republican-controlled Congress, we hope to

continue our successful teamwork, and we hope to work closely with the House and the members of especially this subcommittee in our efforts to improve taxpayers' rights.

Beyond the introduction of this bill, Senator Pryor and I will be working on further improvements and even more pro-taxpayer proposals that will be offered at a later date. This is a truly bipartisan effort. Even President Clinton mentioned to me personally a few weeks ago that he supported our efforts. And we have had quite a few meetings with IRS and Treasury officials who understand that the problem exists and are making an effort to work out agreements.

So I urge my House colleagues to join us, along with Chairwoman Johnson, in the cause to help make the IRS more responsible and more accountable to the taxpayers of this country.

I thank you for this opportunity, Madam Chair, and I look forward to working with you and other members of this subcommittee as we continue this bipartisan effort.

Chairman JOHNSON. Thank you very much, Senator. The kinds of things that you suggest from your legislation are certainly the kinds of things we are interested in, and we look forward to working with you. It may be that if we work effectively not only in a bipartisan way in both Houses but in a bicameral way that we can also give greater visibility to this legislation on the floor.

One of the issues that we are struggling with is the issue of burden of proof, and I wondered whether you would be receptive to expanding the rights of victorious taxpayers to have their attorneys' fees reimbursed by the IRS by requiring the IRS to show that it was substantially justified in maintaining its position in order to deny a taxpayer's claim for attorneys' fees.

Senator GRASSLEY. Yes. The answer is yes, we are willing to consider that. We had it in the 1988 bill. We had to take it out before final passage, but it is something that we have considered before and we would be glad to look at it again.

Chairman JOHNSON. There are some other suggestions in legislation before the House to put the burden of proof in civil tax cases on the IRS. This would reverse current practice, which places the burden of proof on the taxpayer.

Are you looking at changes of that nature?

Senator GRASSLEY. Well, obviously, that is the ultimate of taxpayers' rights, and from that standpoint, that is always a consideration. But it is probably the most difficult one for us to deal with because, of course, the IRS will argue that that takes away the ultimate tool that they have to bring people to prove the amount of tax that is owed.

You will find—I am sure you know this when you ask the question—how very central that is to taxpayers' rights, and yet the strongest arguments from the IRS will come on that particular question.

Chairman JOHNSON. We will certainly be pursuing that with them and with others who testify. It is a difficult issue, but there are some other aspects of that same issue that could be addressed in ways that you suggested from your legislation as well as some of the ideas that have come before us.

I yield to my colleague, Mr. Matsui.

Mr. MATSUI. Thank you, Madam Chairwoman.

Senator Grassley, I like the notion of not only a bipartisan agreement but also a bicameral agreement, as the chairwoman has just mentioned. Do you happen to have an idea of when the Finance Committee might be moving its legislation on this area?

Senator GRASSLEY. Yes.

Mr. MATSUI. Because coordination might be something we might have to work on.

Senator GRASSLEY. Well, obviously, we seldom move any tax legislation without it first coming from the House. We might do some things simultaneously with you. Sometimes we move things out of committee to the floor.

We will not be considering—well, first of all, I don't know whether—I have not heard the chairman say when he was going to consider tax legislation generally, but my guess is that we are going to be, through the first couple weeks of May, working on welfare reform. So it will be after that date.

After that date, this would not have the primary position in the committee. It would be the tax bill that comes from the House of Representatives.

We still have not considered in our own minds whether or not we do some of this legislation through reconciliation—by legislation, I mean tax legislation—or separately. We have to make those decisions.

The final judgment as it relates to this bill, I think at that point, contrary to what Chairwoman Johnson requested, it probably would be considered a part of the tax bill at that point.

Mr. MATSUI. Thank you. I look forward to working with you.

Senator GRASSLEY. You bet.

Chairman JOHNSON. The gentleman from Missouri.

Mr. HANCOCK. I just wanted to thank you, Senator Grassley, for the work you have done over the years in this area. I think that maybe we are approaching a time that we are going to get something accomplished.

Thank you very much.

Senator GRASSLEY. Thank you.

Chairman JOHNSON. Mr. Cardin.

Mr. CARDIN. Thank you, Madam Chairman.

Senator, I think you will find that there is bipartisan support for moving on a Taxpayer Bill of Rights. We obviously want to make sure that where a taxpayer has been wronged there are remedies available.

It seems to me there is a different view as to what impact, financial impact on the agency, some of these proposals might have and whether IRS has sufficient budgetary support in order to carry out many of the requirements that we currently have in the code. I am wondering whether you have done any study in this area, or whether there is any information of which you know, that is available that would either support or not support the notion that some of these problems may be related to the support or lack of resources of the IRS.

Senator GRASSLEY. Well, we are looking into it, but I have to be very candid. It would be difficult to get a firm figure. We have a responsibility in passing this legislation to make sure that it

doesn't detract from the usual efforts and ongoing efforts of IRS. But, additionally, there were tremendous resources in the last budget season given to the IRS, so I think that we need to think in terms of those increases, plus other increases that are being asked in the current budget process, as some flexibility for us to not be concerned, at least that not to be the utmost concern that you present, with these additional resources that have come to the IRS.

Mr. CARDIN. And I agree. It would be useful if we had some independent analysis as to what impact these new requirements may have on IRS, and basically whether these are financial problems within the agency or something else.

Senator GRASSLEY. Well, we know this: that we will have a judgment given to us by the Commissioner and others in the Treasury Department on the costs, and they will have to be a consideration for us to have. But I still think we have to consider the resources that have already been given and are presently asked.

Thank you, Madam Chairwoman.

Chairman JOHNSON. Thank you. Mr. Portman.

Mr. PORTMAN. Thank you.

Senator, thanks for being here and for your good explanation of the bill. I have two quick questions. One is with regard to the taxpayer advocate. I don't have the actual language of your bill in front of me, and I was wondering: Does your legislation contemplate that the President would nominate and the Senate confirm as compared to the IRS Commissioner appointing the ombudsman?

Senator GRASSLEY. Not currently are we considering that much of a change, but the selection not being as important as the independence once it is set up; and, most importantly, the authority of the ombudsman over other people in the taxpayer resolution area, because there is a process set up that isn't so intimidating to taxpayers, a process to get questions answered very quickly, a process that gets around the usual bureaucracy, a process that works fairly well but would work much better if they were within the purview of the ombudsman, or as we call it, the taxpayer's advocate.

Mr. PORTMAN. Tax advocate. And you think that kind of independence would be practical without having a selection process that would be independent of the Commissioner?

Senator GRASSLEY. Yes. I don't believe—although we are giving consideration to other methods as you suggest, although I would say myself I haven't given attention to the question of the President making the choice. After considering those, still the most important view would be the independence of whoever is appointed.

Mr. PORTMAN. One other quick question, and this is a followup to Mrs. Johnson's question to you regarding shifting the burden of proof. Having been chairman of the subcommittee and followed this for years, I just wondered if we could probe a little further into your thinking on this issue. It is a very delicate issue, as you know, and one we will hear more about later, I think, in our further panels. But have you thought about any interim steps where perhaps the taxpayer would have the burden to come forward with some threshold amount of information, data, and so on that the taxpayer

would have and the IRS would not? And then at that point the burden might shift to the IRS to make its case?

Have you thought about those kinds of——

Senator GRASSLEY. We have not thought very deeply about it. We have thought that the chances of making any change whatsoever as opposed to the chance of getting other important pieces of the legislation through, we have thought that the latter has been more important. So we haven't gone into the alternatives. And part of our thought as well was that if we would get an adequate bill of taxpayers' rights, then that diminishes somewhat the changing of the burden of proof.

The burden of proof is something that can be justified a little easier, the extent to which there is less intimidation from the IRS.

Mr. PORTMAN. Thank you very much, Senator. Thanks for coming over.

Chairman JOHNSON. Thank you very much, Senator. It was a pleasure to have you, and we look forward to working with you. Thank you for joining us.

The Honorable Mr. Jacobs of Indiana, please proceed.

STATEMENT OF HON. ANDREW JACOBS, JR., A REPRESENTATIVE IN CONGRESS FROM THE STATE OF INDIANA

Mr. JACOBS. Thank you, Ms. Chairwoman and members of the subcommittee.

About 15 years ago, Representative Crane offered an amendment in committee that provided for attorneys' fees to be paid by the U.S. Treasury to citizens who were brought to court unreasonably by the IRS or without sufficient reason to bring those citizens before the court. At that time I was a member of the committee, and I offered an amendment to Mr. Crane's amendment that would provide that if an agent or an employee of the IRS should cause a citizen to be brought into court and put to expense in an arbitrary or capricious manner—something more than negligence or bad judgment—that the court could order that employee, the one who did it, to pay all or some of the costs to the citizen who was brought into court.

My argument then was what my argument is now. What did the taxpayers do wrong? Why should the taxpayers pay for damage done by an individual at IRS in an arbitrary or capricious, not merely negligent, but arbitrary and capricious manner? For some reason or another, that provision was not adopted.

However, my mother always quoted that if at first you don't succeed, try, try again. In 1986, I offered it to the big so-called tax reform bill that was before the committee. I was told by the chairman that it was not in order until the miscellaneous section at the end of the bill, which happened to come after 3 weeks at about 3 a.m. in this room, as they say in Indiana, of a Sunday. And a lady from the Washington Post—I think her name was Swardson—called me up in Indiana and said, "Isn't it true that this provision passed at 3 o'clock in the morning on a voice vote?" And I said, "That is true, but hardly all of the truth." I said that I had been working on it for however many years then; I guess it has been 15 or 16 now. And while it was passed on a voice vote, it was also passed on a rollcall vote.

Representatives from the IRS were in the room and gave their opinion about the amendment. One of them said, well, it is not a problem because we have internal disciplinary arrangements, and I replied to that by saying so do the doctors and so do the lawyers, and that is precisely why most people have no faith in public institutions anymore, people judging themselves and their peers. Whereupon, it passed by a show of hands 10 to 3. It went on to pass the House.

By the way, this reporter also asked me, wouldn't this have a chilling effect—there is a concept in law that you didn't learn in law school, but have a chilling effect on the performance of duties? And I said I believe it would have a chilling effect on arbitrary and capricious action by any IRS employee.

So how did it come out on the front page of the Washington Post the next morning? Just as you would imagine. Jacobs admitted that it was passed at 3 o'clock in the morning on a voice vote and it would have a chilling effect on the performance of duties by people at the IRS.

Now, I want just to add at least this: I hear it said that this is an insult to the employees at the IRS. Nothing could be further from the truth. We pass murder laws. That is not an insult to the citizens of this country, because very few people commit murder. And I am here to testify that very few IRS agents act in an arbitrary and capricious manner. But I am equally here to say that no service is perfect, and obviously sometimes someplace—I know a couple of cases—such a thing does happen.

Now, when it passed in the most recent tax bill—it has passed the House, I suppose, three times now, and when it passed most recently, the committee wanted to add the words "or maliciously." And I acceded to that. That is fine, exactly what I had in mind, someone who doesn't like your necktie or how you look or something like that.

So it has passed the House, I believe, at least three times, only to die in the cave of the bones, sometimes called the other body, after the IRS went to work on them.

Now, as a former police officer, I know that any time something like this is done with respect to any department of Government, there are many honest apprehensions about the misapplication of it. However, the provision that passed most recently provided as follows: You could not bring an independent action against an IRS agent. It would have to be—it was in the provision—an ancillary proceeding to the actual case itself, which is to say that once the evidence was in and was found wanting, the court could then conduct an ancillary proceeding on motion of the respondent to determine whether there was arbitrary and capricious action. So it didn't cost very much more; it was right there; the judge had already heard the facts and so on. And the judge was not required necessarily to assess the entire cost of the defendant, but the entire cost or any part thereof in the best judgment of the court.

That is about it, except that I hope you give us another chance to try it again, run it up the hill again.

Chairman JOHNSON. Thank you, Mr. Jacobs. That history was very interesting.

It is true that now a taxpayer who has been the subject of arbitrary and capricious action by the IRS can collect attorneys' fees. Is that not true?

Mr. JACOBS. Yes, but they collect them from innocent people, the taxpayers of the United States, even including the respondent, theoretically.

Chairman JOHNSON. I appreciate that. This would for the first time, though, in any Federal agency make the individual Federal employee liable. There is no other parallel in any other agency that we reach to the individual employee.

Mr. JACOBS. Yes. You have to start somewhere, I guess would be my answer to that. I mean, take the exclusionary rule, which we have dealt with recently in the House. The 75-year-old exclusionary rule, evidence obtained unconstitutionally excluded from a case even if it would convict the right person for a heinous murder. It is an outrage to the American public.

I say I am a former police officer. I gather evidence. I present it in court or at least I testify in court. Yes, I would like the person to be convicted. I am a good citizen. I think he is guilty. I think he or she ought to be convicted and punished.

But if you take the boat out of my driveway, it is going to have a lot more effect on my conduct than whether the evidence I gathered in a case makes a conviction. I have always thought that we should not have the exclusionary rule. The discipline should be directly against the officer who is a rogue who gets out of line.

So if this is the place to start, I am happy to be the George Washington of it.

Chairman JOHNSON. Have you had any experience with the internal disciplinary process at the Department?

Mr. JACOBS. I am sorry?

Chairman JOHNSON. You mentioned that you have always been told that the Department had an internal process to deal with individual employees who abrogated this standard. Do you have any comment on their process or do you have any idea whether it works?

Mr. JACOBS. Inherently, it is unacceptable to a civilized people that people judge themselves. I mean, it is what you call inherently incredible that you could have faith in a system where people and peers judge themselves. It is always thought better—we have all heard of the independent counsel. That is exactly what I am talking about.

Chairman JOHNSON. I hear what you are saying when you say it is inherently without credibility but, nonetheless, I think we need to know how it works and whether it has worked, and we will try to get that information on the record.

Mr. JACOBS. There was a case out in the Northwest United States a number of years ago where it was so obvious that the IRS agents were being personal about the respondent. They didn't like the people; they thought they were too snotty or whatever. That culminated in the man's committing suicide, so that the woman would have the insurance money to pay the tax bill.

Don't misunderstand me. I am not anti-IRS. I am not anti-police. Will Rogers said, "It is a great country, but you can't live in it for nothing," when he talked about taxes. Some people are just knee-

jerk. That is wrong. I want the highways, I want the police protection, I want the national defense, but I don't want to pay a nickel in taxes because that is un-American. Well, that is also nuts.

So I don't take that position at all. But I just say in those tiny little instances where that happens, the person who did it should pay, not the innocent taxpayers. That is my reaction. And, apparently, that argument went over. It has passed the House three times.

Chairman JOHNSON. Thank you.

Mr. Matsui.

Mr. MATSUI. Thank you.

Andy, I will tell you, I understand what you are saying, but don't you believe that the administrative process—I mean, if an agent is found to have committed a malicious act, what about the administrative process? They could be fired. They could be disciplined. There is a whole wide variety of actions that can be taken against them.

If we emphasize that, do you think that would have the same kind of deterrent effect as the issue of liability? It would seem to me that the whole notion of creating individual responsibility really changes the whole concept of what we are trying to do here, because I do believe it could have some chilling effect on others. You know, then you are at kind of the burden of a court system, and we know how jury trials are. Sometimes they work, sometimes they don't. Sometimes it depends upon how slick a lawyer is. Perhaps you can——

Mr. JACOBS. I just don't think murder laws have a chilling effect on most of us who don't tend to commit murder, and I don't think that a rule against arbitrary, capricious, and malicious action is going to have much effect, chilling effect—that is the term—on the IRS agents.

At first, I think they made some useful suggestions, by the way, when they said, What if somebody, a disgruntled taxpayer, just filed a suit against us? This has gone through a metamorphosis through the years. We changed that to make it an ancillary proceeding to the actual case itself, and nobody has standing to bring action against those individual agents. We trimmed this thing down quite a bit over the years, but I think it is down to the point now where it accomplishes the forensic purpose that I have described.

You asked me do I have faith in internal tribunals for misconduct of one's peers and people. No, I don't, and I don't think most Americans do. Most Americans understand the concept of conflict of interest.

Mr. MATSUI. Thank you.

Chairman JOHNSON. Thank you.

Mr. Hancock.

Mr. HANCOCK. I have absolute, complete sympathy with where we are heading here. There is no question about it. But I do have a little bit of a problem. This is a major change in the principle of agency, where the agent of an employer is on their actions, you can always go against the employer, which is true in the private sector. As a small businessman, if I have got a serviceman out here and

he does certain things, if he is at my direction, then I am responsible.

Mr. JACOBS. That is the whole point, sir. It is not at the direction. It is ultra vires. It is something beyond. Only under the color authority—you didn't do anything wrong if one of your people goes out and rapes a woman.

Mr. HANCOCK. I will agree, as long as it is a criminal action.

Mr. JACOBS. But he couldn't have gotten in the house if he hadn't been your serviceman.

Mr. HANCOCK. Well, that is true, but what about if I send somebody out to collect a bill and they get carried away? I mean, no criminal charges of any kind, but they get carried away on how they collect the bill and violate the laws on how to collect a bill. I have to answer for that. In fact, if my employee is out there doing the job and that individual brings a suit against me, then I am going to have to defend that suit and defend the employee, and probably they would get a judgment against me, similar to what we have——

Mr. JACOBS. They probably won't win the suit if you didn't direct him to do the crime.

Mr. HANCOCK. Well, my point is, are we talking about the agent or are we talking about the steps through his supervision?

Mr. JACOBS. We are talking about whoever took sets on somebody because he didn't like him. It is a fact situation.

Mr. HANCOCK. Sure, OK.

Mr. JACOBS. Someone who just took sets on someone, didn't like his race, didn't like his necktie, didn't like the fact they both wanted to go out with the same woman, whatever. That is the kind of case we are talking about. I am not talking about just some casual, let's go after one guy because we hate the service. I am talking about a fact situation, where it is arbitrary, well defined in the law already, capricious, and malicious. Now, that is a pretty heavy load to prove, and I don't think there is a danger.

As far as the major change is concerned, the last time I heard, the majority in this Congress favored some major changes.

Mr. HANCOCK. Do you know about any specific cases where the Internal Revenue Service may have initiated something on this order as an effort to make an example of the taxpayer where it could be talked about to make other people nervous?

Mr. JACOBS. You say an example?

Mr. HANCOCK. Yes.

Mr. JACOBS. Well, I just cited one, the one out in the Northwest a few years ago. And there are others. There are others.

We had a guy out in Indianapolis, an agent, a few years ago, called up one of the largest builders in the United States. Nobody knew how he got the direct line, but he did, and he got hold of the president of the company. And he got a little snotty with him and went on and on and on and on and on. And this guy said, you are nuts, I file my income tax by the boxful, and talk to my accountant, this is the first I heard of it.

This young agent called back, I think six times over a period of time. The fellow should have had his phone changed, I guess. But he called back six times, and somewhere along the line, surely he

would know that this was an honorable person. I don't know whom he was after.

Now, you might say, well, that is negligence. But after six times, you might have taken the trouble to look up what you are doing and find out. That was sort of borderline. I don't say it did any great harm. I guess this fellow had better things to do than be yelled at over the phone by an IRS agent.

Mr. HANCOCK. Thank you.

Chairman JOHNSON. Mr. Cardin.

Mr. CARDIN. Well, Andy, I think all of us agree that in the type of cases you are referring to, the taxpayer should have full rights and that there should be action taken against the Federal employee who has treated a person in that manner.

I get lots of complaints in my office about all Federal agencies, including the IRS, and the overwhelming number, perhaps all, would not fall into the category that you are referring to, those extreme cases.

Shouldn't we be looking for some balance in trying to deal with the problems that taxpayers have with the IRS by supporting additional efforts to modernize the way that the IRS handles the tax compliance issue by providing the resources which they need to modernize their facilities?

Mr. JACOBS. Absolutely. Absolutely. But you can't modernize a bad heart, and that is all this is about.

Mr. CARDIN. Yes, I understand.

Mr. JACOBS. That occasional rogue who, under color of authority, does damage to American citizen, and the whole issue here is whether other Americans citizens who didn't do that at all should be forced to pay taxes to pay for that person's—pay the damage, or should the person, the rogue, pay the damage? It passed the House three times. You voted for it.

Mr. CARDIN. I agree with you. We are in agreement. But I just believe that, unfortunately, we are trying to put so many things into the one category, so many types of constituent problems with the IRS into the one category, and trying to deal with a bill to deal with that category, where a large amount of the frustration that my constituents have with IRS is due to that Congress has not made available the resources for the IRS to modernize.

Mr. JACOBS. I acknowledge right readily that this is not a panacea. This is not the complete link. This is to deal with one specific problem, which is nothing less than an outrage. What is it Solon said? That civilization is impossible until the unconcerned are as outraged as the victim. I am outraged if you are wronged in that arbitrary and malicious fashion. It doesn't have anything to do with mistakes of the IRS. God knows we all make those. This is where intentional, heinous behavior occurs. That is all I mean. It is just an element.

Chairman JOHNSON. Mr. Portman.

Mr. PORTMAN. Thank you, Mrs. Johnson.

Andy, a few questions, but first just a comment on what Mr. Cardin said. I agree that modernization would help. I think more important would be simplification of the Tax Code rather than modernization, because I think if people understood clearly what

their rights were on both sides, the taxpayer side and the IRS side, there would be fewer instances of the kind that you mention.

But let me probe this a little further, and I do consider you the George Washington of this effort, as you know, the father of personal responsibility here. Arbitrary and capricious is a standard you use, which is the Administrative Procedures Act standard for rulemaking, and it is a pretty well established standard. There are a lot of court cases on it which would provide some sort of a safe harbor.

You also mentioned malicious behavior was added; you indicated at one point that it was arbitrary and capricious and malicious.

Mr. JACOBS. I beg your pardon.

Mr. PORTMAN. Is it and or or?

Mr. JACOBS. It is a disjunctive. It is or.

Mr. PORTMAN. Otherwise, it would be quite narrow, I would think.

Mr. JACOBS. It would be self-contradictory, I agree, but it is a disjunctive.

Mr. PORTMAN. I think that an important point to make is that there is, with the conjunctive, even, a lot of case law out there and that the standard—certainly if arbitrary and capricious is well established, I think that is important to have a safe harbor so that people understand on the IRS side what behavior would go over the line.

The second question is, you talked about the ancillary proceedings. You indicated that that would affect standing. It would limit people's ability to bring suits. Would it also, Andy, help with the situation with a lot of these tax litigation matters that go on and on for months, even years, and I would think there would be a cloud hanging over the head of the IRS agent during that time period. Having ancillary proceedings, does that affect that situation at all?

Mr. JACOBS. Rob, it is hard for me to believe that during the case in chief much of the evidence of what I am talking about, if it existed at all, would not have been heard by the trier of the facts, the judge. So I think that my perception is that the ancillary proceeding could be conducted in fairly rapid order.

Mr. PORTMAN. Another question I have relates to the cost of the taxpayer's legal fees. It is my understanding that you are asking that there be a personal liability on the part of the agent to pay those costs.

Mr. JACOBS. All or some part, yes.

Mr. PORTMAN. All or some part? And that is within the discretion of the trier of fact, of the judge.

Have you thought about putting some sort of a cap on that, Andy, to limit that liability at some——

Mr. JACOBS. Well, it wouldn't bother me. Yes, I think that would be reasonable. In other words, if a respondent gets his brother-in-law and figures he is going to get his fee paid, and he said, well, we will just make a $1 million fee, absolutely, I think that would be very—I am glad you mention it. I think that would be very helpful.

Mr. PORTMAN. Well, I thank you very much for bringing this issue before us. I am new on the committee, as you know, and

haven't had a chance to explore it yet. I look forward to seeing the statutory language, and I appreciate your continuing to push the effort.

Mr. JACOBS. Thank you very much.

Mr. PORTMAN. Thank you, Madam Chairwoman.

Chairman JOHNSON. Mr. Zimmer, would you like to inquire?

Mr. ZIMMER. I have no questions. Thank you.

Mr. JACOBS. Thank you.

Chairman JOHNSON. Andy, thank you very much for your good testimony and for your long work in this area, your perseverance over many years.

Mr. JACOBS. Thank you, Mrs. Chairwoman.

Chairman JOHNSON. We have appreciated it.

Our last witness on the panel is not here. When he arrives, we will visit with him. We will insert his statement into the record.

I would like to call the first panel: Hon. Peggy Richardson, the Commissioner of the Internal Revenue Service; and with her, Lee Monks, the Taxpayer Ombudsman from the IRS; and Cynthia Beerbower, Deputy Assistant Secretary of the Department of Treasury.

Deputy Assistant Secretary Beerbower, we are pleased to have you. I think this is your first appearance before our committee, and we are pleased to have you represent the Department of Treasury for tax policy.

STATEMENT OF CYNTHIA G. BEERBOWER, DEPUTY ASSISTANT SECRETARY FOR TAX POLICY, U.S. DEPARTMENT OF TREASURY

Ms. BEERBOWER. Thank you very much, Madam Chair and members of the subcommittee.

Chairman JOHNSON. Nice to have you, Ms. Beerbower. Why don't you go ahead?

Ms. BEERBOWER. In response to the subcommittee's request, I am pleased to present the views of the Treasury Department on many of the important issues of taxpayer rights. The administration supports many of the ideas in the legislation that we will be discussing today. Treasury has worked with the Internal Revenue Service to develop a package of administrative changes, including certain regulatory simplification to help taxpayers reduce the burdens of compliance. We have also been meeting with congressional staff, and we have been working on legislative initiatives that build upon the original Taxpayer Bill of Rights.

Commissioner Richardson in her testimony will discuss some of the new ideas that have emerged from our dialog with staffs. I want you to know we remain strongly committed to reducing taxpayer burden and safeguarding taxpayer rights in dealing with the IRS.

Last year, the Treasury Department supported the passage of tax simplification and technical corrections. It contained numerous provisions from the Taxpayer Bill of Rights II that were originally contained in H.R. 11. Although H.R. 3419 passed in the House, the legislation was never taken up in the Senate.

In its fiscal year budget for 1996, the administration has stated that it continues to support revenue-neutral initiatives designed to

promote sensible, equitable administration of the Internal Revenue laws. We support simplification and technical corrections. In addition, the budget describes the administration's support of compliance and enforcement measures. We have stated we support the reinstatement of authority to share information on cash transaction reports, and to fund undercover operations. We are working on intermediate sanctions, modernizing and streamlining IRS operations, and compliance with diesel dyeing.

The administration has also actively supported and pursued administrative measures to ease taxpayer burdens. In fact, the day before yesterday, the IRS issued a notice that relieves taxpayers who made charitable contributions of $250 or more from the statutory requirement that they obtain written acknowledgment from the charities for their 1994 returns. The IRS provided this relief because we have been hearing from a number of people of the difficulties that they have had in securing this written acknowledgment.

I detailed in my written testimony many of these initiatives that we have taken in order to simplify and in order to respond to problems individual taxpayers have had with the compliance burden.

Today, you have asked for our views on three pieces of taxpayer rights legislation that have been introduced in the 104th Congress: H.R. 390, which was introduced by Representative Traficant; S. 258, which was introduced by Senators Pryor and Grassley; and H.R. 661, which was introduced by Representative Thornton. You have also asked that we respond to title V of H.R. 11, which was passed by both Houses of Congress in 1992, but vetoed by President Bush.

In preparing our testimony today, we have reviewed the prior testimony in this area by Treasury officials. It is interesting to note that over a long period of time and regardless of the political affiliation of the administration, the testimonies of Treasury officials have been essentially consistent. Treasury has always cautioned Congress that compliance with our tax laws depends upon the public's perception that the tax laws are fairly administered and that the IRS has the ability to catch and to prosecute violators.

Our tax system has as its foundation voluntary self-assessment and compliance. The IRS only audits 1 percent of all returns. It is because of the dependency of the entire tax system on this voluntary compliance that Treasury approaches the subject today with caution.

There are three prerequisites to a successful voluntary tax system. First, the system must be fair and must be perceived as being fair. Second, taxpayers must be treated with respect and dignity. The enforcement mechanism should not be more intrusive or burdensome than is necessary for sound tax administration. Third, the system must operate efficiently and at a reasonable cost. If we increase the governmental cost of tax collection without commensurately increasing the benefit to taxpayers, we have wasted the taxpayers' dollars.

With these criteria in mind, we believe that certain important provisions in the proposed legislation will be very useful and valuable. However, we have serious reservations about other proposals. Although these proposals are well intentioned, we believe that they

could significantly undermine fairness, respect, and efficiency, and ultimately erode voluntary compliance with our laws.

I would like to focus initially on H.R. 390. This bill contains three sections. Our comments on the second and third sections are included in the written testimony. I would like to highlight the first section of H.R. 390, because that section concerns us very much.

Those of you who are lawyers know that the general rule is that the burden of proof in a civil proceeding is on the party who is in control of the facts. By contrast, in a criminal proceeding, such as a proceeding for criminal—or civil—fraud, the burden shifts to the Government.

There is much case law and it is in our written testimony that details the development of this legal doctrine. It is probably best summed up in a 1975 ninth circuit case called *Rockwell* v. *Commissioner* that reaffirmed the Tax Court rules, imposing the burden of proof on the taxpayer. The ninth circuit said even if it were to decide the burden of proof issue in the first instance, the court would impose the burden on the taxpayer. The taxpayer knows the facts, and he can testify as to what his intent or his purpose was. The Commissioner, on the other hand, must rely on circumstantial evidence, and most of it has to come from taxpayer records. So it is not unfair, said the ninth circuit, to impose the burden on the taxpayer to pursue the facts.

Section 1 of H.R. 390 would change this longstanding and well-established legal doctrine. What it would do is place the burden of proof on the Government in all tax cases for all issues.

While this provision may be relatively simple and innocuous on its face, we believe that it will have enormous and far-reaching adverse effects on the tax system. We believe, in particular, that it will result in a significant reduction in the willingness of taxpayers to comply voluntarily with their tax obligations, and it would greatly encourage tax protesters.

It is difficult to grasp a change of this magnitude. However, in fiscal year 1994, the IRS examined—through regular examinations and information return program contacts—4 million taxpayers. A vast preponderance of these audits were conducted by correspondence. Under the new provision, a taxpayer receiving a letter can simply refuse to provide the requested information.

The IRS would then be forced to do a face-to-face audit of the taxpayer. But even then, the taxpayer can refuse to cooperate. If so, the IRS is forced to disprove the items on the taxpayer's return. This would often be impossible. It would require extensive investigation by the IRS, lengthy face-to-face interviews of persons other than the taxpayer, and often the need to summon information from third parties.

As a result, the simplest audit would become a costly nightmare if taxpayers refused to cooperate. Taxpayers can wait for the Service to come up with the proof, and if the IRS gives up or abandons the effort, the taxpayer would automatically win.

Consider a few real-world examples of tax compliance, facts that the IRS would have to prove: one, if a taxpayer claimed a child as a dependent and the IRS suspects that the child does not exist, the IRS would be forced to interview neighbors; two, if the taxpayer claimed that he or she supplied more than half of the support of

a dependent, the IRS would be forced to prove that someone else provided more than half of the support of that dependent; three, if a taxpayer claimed that a certain piece of art that it has given to charity was worth $1 million, the taxpayer could just wait, and the IRS would have to prove that that particular piece of art was worth less; four, if a taxpayer claimed a $200,000 mortgage interest deduction, the IRS would be forced to summon the bank and prove that the interest had been paid and that the principal amount of the mortgage exceeded the $1 million limit; five, if a taxpayer claimed to be over 65 or if he claimed to be blind, the IRS would have to summon records to prove to the contrary; six, if a taxpayer claims lavish entertainment expenses, the IRS would have to disprove the expenses or the business purpose of the event by summoning waiters and credit card receipts; and seven, if a taxpayer claimed that his gambling winnings were offset by gambling losses, the IRS would have to prove that that taxpayer did not have the gambling losses.

The results in the business arena would be equally bizarre. If a foreign-owned U.S. company reported no profits and the IRS claimed there should be intercompany pricing adjustments that would result in profits, the IRS would have the burden of proving that the U.S. company had overpaid its foreign affiliate. This contradicts with the rule today, under which the company has to prove that it did not overpay. If a taxpayer claimed exemption from the passive loss rules for real estate by claiming that he or she worked more than 500 hours in the activity during the year, the taxpayer would need to show nothing, and the IRS would have to somehow disprove that claim.

The change in the burden of proof would have significant implications in the tax shelter area. Many tax shelter cases turn on whether the taxpayer can establish that the transaction or the investment was entered into with the intention of making a profit or was solely entered into to manufacture tax deductions. We believe it is reasonable for the taxpayer to have the burden of proving his own business motive. To do otherwise would open the door to shelters ranging from complicated corporate financial transactions to wealthy taxpayers who buy ranches as vacation homes and deduct the cost of what in reality is their vacation.

The bill would be an obvious boon to tax protestors, who would claim all sorts of deductions to zero out their incomes. The IRS would spend endless hours having to disprove each item on the protestor's return. Protestors would no doubt become extremely creative in claiming deductions that would cause the maximum difficulty for the IRS to disprove.

In fact, when we were preparing our testimony, we thought that section 1 of H.R. 390 could be named the Tax Protestors Relief Act.

There also would be a significant impact on the IRS appeals process, which has to take into account the hazards of litigation in settling cases. With the burden of proof on the Government, the IRS would be placed in a no-win position. It would either have to try to settle more cases for reduced amounts or proceed to court. Most taxpayers would not want to settle. They would hold out for court proceedings where they can simply sit back and relax. This choice would have little to do with the merits of the case, and it

would have everything to do with the IRS' ability to find the necessary records to prove the taxpayer's deductions.

H.R. 390 would also compromise taxpayer privacy. It would cause audits to be much more time-consuming and burdensome. The Service would be forced to conduct more extensive and intrusive investigations of the taxpayer. And if the taxpayer did not cooperate, third parties, such as banks and credit card companies, would be required to furnish lots and lots of information to the IRS. These documents would be viewed by third parties as very burdensome.

The system would also operate less efficiently, and it would be less able to deliver quality services at a reasonable cost. The choice really is: Will increased funding be provided for the IRS in order to enable them to carry some of this burden? Or will the funding remain the same and there simply be a reduction in the audit activity?

Just consider the task of disproving the existence of a child. If I claim that I have a baby, how are you going to prove that I don't? The fact that my neighbors never saw one or the grandparents don't know about one does not prove that the child does not exist.

Chairman JOHNSON. Ms. Beerbower, I really appreciate the specificity of your testimony. It is very helpful to the committee. But if you could summarize parts of it and continue with other parts, I would appreciate it.

Ms. BEERBOWER. I will.

There are many more arguments against H.R. 390 detailed in our written testimony. We have commented, as I said, on the other two sections of H.R. 390, but the length of my discussion on the matter is really designed to reflect the importance we place on the burden of proof and the magnitude of the change that is embodied in H.R. 390.

In evaluating H.R. 390, we ask you to consider whether it is in the long-term best interest of taxpayers to force the IRS to administer and enforce the tax laws with this handicap.

Although Treasury has not formally estimated the cost of this proposal, its cost is very large, and the trust of law-abiding citizens who do comply with the tax laws would be eroded.

I would like to conclude with a few comments on the other pieces of legislation, the Taxpayer Bill of Rights legislation that you have asked us to comment on.

As I said, Treasury and the IRS worked closely with Members of Congress and their staffs in developing the 1988 Taxpayer Bill of Rights. We are continuing to meet with congressional staffs to develop new ideas. Commissioner Richardson will go into these new ideas, and I need not at this point.

The two versions of the Taxpayer Bill of Rights that are the focus of this hearing are similar in most respects. I want you to know that we support many of the provisions in their current form and have suggested minor modifications. We have been discussing these modifications with congressional staff.

At the current time we understand that there are roughly 40 sections in each bill, and we have major disagreements with only a small number of them. We are supportive of the great bulk of the

bill, and the detail of our support is outlined in the written testimony.

I think with the balance of my time I would like to focus on just a few areas where our disagreement is very strong.

The taxpayer advocate provisions that are contained in the Taxpayer Bill of Rights II will be dealt with in detail, not only by the ombudsman but by the Commissioner.

Under current law, as you know, the administration's tax initiatives are not presented to Congress until they are cleared by the executive branch, the Office of Tax Policy, and the Office of Management and Budget. This coordinated clearance process is an important part of the function that we serve. In the Taxpayer Bill of Rights provisions in H.R. 661 and H.R. 11, the ombudsman would not only be required to submit annual reports to Congress, but he would be asked to give legislative ideas to Congress without being reviewed by the Office of Tax Policy, the IRS, or OMB.

Now, we like to believe that the ombudsman is independent. We support his independence. We are pleased that there is no mandate that the President select him and that his selection be confirmed by the Senate. And we applaud the deletion of this provision. But we believe that the administration should speak with one voice on tax proposals.

The administration needs to take into account its own priorities, the views of the Secretary of the Treasury, the concerns of many agencies, and in the Office of Tax Policy, we do believe that we provide significant technical revenue estimating and policy input.

We also need the administrative input of the IRS. In short, we believe that to change the reporting responsibilities on tax legislation of the ombudsman would essentially deny the executive branch the right to present Congress with a balanced economic agenda and would certainly undercut the role of the Secretary of the Treasury as the spokesman on the administration's fiscal matters.

We work with the IRS. We want you to know that Treasury has taken quite an interest in the administration of tax returns. Both Mr. Samuels and I have asked to visit Service centers in the next few weeks to see what type of burden they deal with. Last year, I went out to California to meet with the agents, and I was very interested in a lot of the comments they made about the difficulties they face.

We work with the IRS on legislative ideas, but we have been somewhat frustrated by the lack of opportunity to present good-government, legislative solutions. In 1993, tax provisions were viewed as nongermane to budget reconciliation. In 1994, there were no tax provisions in the budget. And in this current budget, while we have set them forth, we think that this committee needs to make a special effort—and it has done and we applaud what it has done in technical corrections—to place what is probably less glamorous tax legislation on the agenda and fight for its enactment.

I would also like to comment on the provisions providing for installment agreements as a matter of right and for the suspension of penalties that are in the Taxpayer Bill of Rights. You need to remember that most law-abiding and fiscally responsible taxpayers pay their tax liabilities on time. These provisions would encourage them not to. We have several examples in the written testimony,

but one thing to consider is the difference in the rate of interest on payments to the Federal Government and the rate of interest on a credit card balance.

If this legislation goes through the way it is, I would certainly expect people in the private sector to give advice to anyone that has an outstanding credit card balance, that it is far more tax efficient to pay the credit card balance before you pay your taxes. This is because in many instances I think the rate right now on credit cards is about 15 percent, whereas the rate on payments to the Government is 8 percent. It is clearly in your interest to pay down your credit card balance before you pay your taxes.

If the rate of interest on amounts owed the Government is less than the return that you get on your investments, you also would have an incentive to make these investments instead of paying the Government. And making these installment agreements a matter of right we think would seriously undermine efforts to pay your tax on time.

My final comments really deal with retroactivity. In H.R. 661, section 903 generally would prohibit us from issuing retroactive regulations. There are a number of exceptions that are detailed. There was a very useful provision in H.R. 11 that was dropped in the current legislation. It would have allowed regulations issued within 12 months of enactment of a statute to relate back to the date of enactment. But the authority to issue regulations retroactive is a great concern for us. There have been a lot of studies done of situations when the Treasury has acted retroactively, and I am not aware of any study that has ever concluded that we have engaged in a pattern of misuse or irresponsibility with respect to our authority to act retroactively.

If we were prohibited from acting retroactively, we would establish a window in the period of time between when changes in statutes occur and when the regulations that detail the manner in which one complies with those statutes are issued. Taxpayers would basically race against the Treasury in order to get their transactions in that window. We see constantly the arbitrage opportunities that are created in the financial markets that rely on the slowness of the Government to act, and we need the power to continue to at least threaten to act in many instances retroactively to prevent this type of arbitrage from occurring.

Despite these concerns, and in conclusion, we remain committed to the Taxpayer Bill of Rights. We believe we can work with this committee and can make the provisions better. And we look forward to that.

This concludes my prepared remarks, although I will stay for questions until after the Commissioner and the ombudsman have divided. Thank you.

[The prepared statement follows:]

STATEMENT OF
CYNTHIA G. BEERBOWER
DEPUTY ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

Madam Chair and Members of the Subcommittee:

In response to the Subcommittee's request, I am pleased to present the views of the Department of the Treasury on the important issue of taxpayer rights. This Administration supports many of the ideas in the legislation we will be discussing today. Treasury has been working with the Internal Revenue Service (IRS) to develop a package of administrative changes, including certain regulatory simplification to help taxpayers reduce the burden of tax compliance. We also have been meeting with Congressional staff to develop legislative initiatives that build on the original Taxpayer Bill of Rights.

Commissioner Richardson, in her testimony, will discuss some suggestions that have emerged from these dialogues. We remain strongly committed to reducing taxpayer burden and safeguarding taxpayer rights in dealing with the IRS.

Last year, the Treasury Department supported the passage of The Tax Simplification and Technical Corrections Act of 1993, H.R. 3419, which contained numerous provisions of the Taxpayer Bill of Rights 2, as originally contained in H.R. 11. Although H.R. 3419 passed the House on May 17, 1994, the legislation was never taken up in the Senate. In its Fiscal Year 1996 Budget, the Administration stated that it continues to support revenue-neutral initiatives designed to promote sensible and equitable administration of the internal revenue laws, including simplification and technical corrections. In addition, the Budget describes the Administration's support of such compliance and enforcement measures as reinstatement of authority to share information on cash transaction reports within the law enforcement community and to fund undercover operations. In the Budget, we also state that we support and want to work with Congress on proposals involving intermediate sanctions, the modernization and streamlining of IRS operations, and compliance with diesel dyeing requirements.

The Administration also has actively pursued administrative measures to ease taxpayer burdens. For instance, just this week, the IRS issued a notice relieving taxpayers who made charitable contributions of $250 or more from the statutory requirement that they obtain adequate written acknowledgements from the charities before they file their 1994 returns. The IRS provided this relief because of difficulties taxpayers are experiencing in obtaining these acknowledgements. As another example, in 1993 the IRS issued a notice providing relief for individuals who want an automatic four-month extension to file their tax returns, but who are unable to pay by the original due date the amount of tax estimated to be due. Although such taxpayers would still be liable for interest and late-payment penalties, they are relieved of the late-filing penalty that otherwise would apply.

In addition, the Administration has taken numerous administrative measures to make it easier for small businesses to deal with the tax system. The Administration routinely issues regulations designed to minimize or eliminate burdensome recordkeeping requirements on small businesses. For example, the Administration recently issued regulations reducing the reporting requirements necessary to claim an ordinary loss deduction on the sale of small business stock, simplifying return preparation for taxpayers subject to the alternative minimum tax, and simplifying the calculations for determining the amount of depreciation deductions for small businesses. The Administration has also issued guidance designed to assist small businesses in complying with complicated tax provisions -- for example, by issuing a revenue procedure that will greatly assist the rapidly growing number of small businesses that elect to operate as limited liability companies.

Today, you have asked for our views on three pieces of taxpayer rights legislation that have been introduced in the 104th Congress: (1) H.R. 390, which was introduced by Representative Traficant and others on January 4, 1995; (2) S. 258, which was introduced by Senator Pryor, Senator Grassley and others on January 23, 1995; and (3) H.R. 661, which was introduced by Representative Thornton on January 24, 1995. Because S. 258 and H.R. 661 are the same, I will refer to H.R. 661. You have also asked that we review Title V of H.R. 11, which was passed by both Houses of Congress in the Revenue Act of 1992, but vetoed by President Bush.

In preparing our testimony, we have reviewed the prior testimony in this area by Treasury officials. It is interesting to note that over a long period of time and regardless of the political affiliation of the Administration at the time, the testimonies of Treasury officials have been consistent. Treasury always has cautioned Congress that compliance with our tax laws depends upon the public's perception that the tax laws are fairly administered and that the IRS has the ability to catch and prosecute violators. Our tax system has as its foundation voluntary self-assessment and compliance. The IRS currently audits only approximately 1 percent of all returns. Since we depend upon voluntary compliance, Treasury approaches this subject today with caution.

There are three prerequisites to a successful voluntary tax system. First, the system must be perceived as being fair. Fairness requires that similarly situated taxpayers be treated similarly. The success of our system, therefore, hinges on each of us believing that if we pay our share of taxes, others will do the same.

Second, taxpayers must be treated with respect and dignity. The enforcement mechanism should not be more intrusive or burdensome than is necessary for sound tax administration.

Third, the tax system must operate efficiently in a manner that provides quality services to taxpayers at a reasonable cost. If we increase the governmental costs of tax collection, without commensurately increasing the benefits to taxpayers, the taxpayers' dollars will be wasted.

With these criteria in mind, we believe that certain important provisions of the proposed legislation will be useful and valuable. However, we have serious reservations about some of the other proposals in the proposed legislation. Although these proposals are well-intentioned, we believe that they could significantly undermine fairness, respect and efficiency, and ultimately erode voluntary compliance with our laws.

I. H.R. 390

I would like to focus initially on H.R. 390. This bill contains three sections. The first section, about which we have major concerns, would place the burden of proof on all issues in all tax cases in court on the government.

S 1. Burden of Proof

Current law. The general rule in civil proceedings is that the burden of proof is on the party that has control of the facts. By contrast, in criminal and certain penalty proceedings (such as civil fraud), the burden shifts to the government.

In the tax context, the general civil rule is articulated well by the Ninth Circuit case of Rockwell v. Commissioner, 512 F.2d 882 (9th Cir. 1975). In this case, the U.S. Court of Appeals for the Ninth Circuit held clearly that the burden of proof rests with the taxpayer both to produce evidence that rebuts the Commissioner's determination and to persuade the court of the correctness of the taxpayer's position. This, the court said, is proper and does not deny the taxpayer his right to due process of law. The court said if it were to decide the issue in the first instance, it would establish and uphold this rule:

> "The taxpayer knows the facts . . . . He can . . . testify as to what his intent or purpose was. The Commissioner, on the other hand, must rely on circumstantial evidence, most of it coming from the taxpayer and the taxpayer's records . . . . It is not at all unfair, in such a case, to place on the taxpayer the burden of persuading the trier of fact. . . " Id. at p. 887.

Proposal. Section 1 of H.R. 390 would change this long-standing and well-established legal doctrine in the tax context. It would place the burden of proof on the government for all issues in all tax cases in court. Section 1 provides: "Notwithstanding any other provision of this title, in the case of any court proceeding, the burden of proof with respect to all issues shall be upon the Secretary."

Discussion. While this provision may appear to be relatively simple and innocuous on its face, we believe it will have enormous and far-reaching adverse effects on the tax system. In particular, we believe it will result in a significant reduction in the willingness of taxpayers to comply voluntarily with their tax obligations and would greatly encourage tax protestors.

It is difficult to grasp a change of this magnitude. However, in Fiscal Year 1994, the IRS examined (through regular examinations and information return program contacts) four million taxpayers. Most of these audits are conducted by correspondence. Under the new provision, a taxpayer receiving a letter could simply refuse to provide the requested information.

The IRS would then be forced to do a full face-to-face audit of the taxpayer. But even then, if the taxpayer refused to cooperate, the IRS would be forced to disprove the items shown on the return. This would often be impossible. It would require extensive investigation by the IRS, lengthy face-to-face interviews of persons other than the taxpayer, and often the need to summon information from third parties. As a result, the simplest audit would become a costly nightmare if the taxpayer refuses to cooperate. The taxpayer could wait for the IRS to come up with proof and, if the IRS abandons the effort, the taxpayer automatically "wins."

For example, (1) if a taxpayer claims a child as a dependent and the IRS suspects the child does not exist, the IRS would be forced to interview neighbors; (2) if a taxpayer claimed that he or she supplied more than half the support of a dependent, the IRS would be forced to prove that someone else provided more than half; (3) if a taxpayer claimed that art given to charity was worth $1,000,000; the taxpayer could just wait, and the IRS would have the burden of proving it was worth less; (4) if a taxpayer claimed a $200,000 mortgage interest deduction, the IRS would be forced to summon the bank to prove that the interest had been paid and that the principal amount of the mortgage exceeded the $1,000,000 limit; (5) if a taxpayer claimed to be over age 65 and/or blind, the IRS would have to summon records to prove the contrary; (6) if a taxpayer claimed lavish entertainment expenses, the IRS would have to attempt to disprove the expenses (or the business purpose of the event) by summoning waiters and credit card receipts; and (7) if a taxpayer claimed that his gambling winnings were offset by gambling losses, the IRS would somehow have to prove that he did not have the losses.

The results in the business arena would be equally bizarre. If a foreign-owned U.S. company reported no profits, and the IRS claimed there should be intercompany pricing adjustments that would result in profits, the IRS would have the burden of proving that the U.S. company had overpaid its foreign affiliate, rather than (as today) the U.S. company having to prove that it did not overpay. If a taxpayer claimed exemption from the "passive loss" rules for real estate because he or she worked more than 500 hours in the activity during the year, the taxpayer need show nothing, and the IRS would have to somenow disprove that claim.

The change in the burden of proof also would have significant implications in the tax shelter context. Many tax shelter cases turn on whether the taxpayer can establish that the transaction or investment was entered into with the intent to make a profit or instead was solely to manufacture tax deductions. We believe it is reasonable for the taxpayer to have the burden of proving its own business motives. To do otherwise would open the door to shelters ranging from complicated corporate financial transactions to wealthy taxpayers who buy ranches as vacation homes and then deduct the cost of what in reality is the cost of their vacation.

The bill would also be an obvious boon to tax protestors, who would claim all sorts of deductions to zero out their income. The IRS would spend endless hours having to disprove each item on the return. Protestors would no doubt become extremely creative in claiming deductions that would cause maximum difficulty on the part of the IRS to disprove.

There also would be a significant impact on the IRS Appeals Office, which is required to take into account the hazards of litigation in settling cases. With the burden of proof on the government, the IRS would be placed in the "no win" position of either having to settle more cases for reduced amounts or to proceed to court. This choice may have little to do with the merits of the case and everything to do with the IRS's ability to obtain the necessary records.

Section 1 of H.R. 390 also would compromise taxpayer privacy and cause audits to become much more time-consuming and burdensome. The Service would be forced to conduct more intensive and intrusive investigations of the taxpayer and, if the taxpayer did not cooperate, third parties such as banks and credit card companies would be required to provide information to the IRS. These document requests would be viewed as imposing new burdens on these third parties.

The system also would operate less efficiently and would be less able to deliver quality services at a reasonable cost. The provision either would require increased funding for the IRS or a reduction in audit activity. Consider the task of disproving the existence of a child. If I claim that I have a baby, how are you going to disprove that? The fact that my neighbors never saw one or the grandparents never heard about one does not prove that the child does not exist. Even the lack of a birth certificate does not prove it.

The IRS would have to spend more time developing and litigating cases, even though it would have less chance of winning them. Audit resources would be spread even more thinly, and the audit rate would decline further. More summonses would be issued and more efforts would have to be exerted attempting to obtain district court enforcement of them. Because the statute of limitation on assessments would remain unchanged, this dilution in audit resources would effectively immunize more and more deficiencies from assessments. The ultimate result would be that IRS audits would only be cost-effective if very large amounts of money were at stake, inviting taxpayers to disregard the rules and fostering disrespect for the system.

In evaluating section 1 of H.R. 390, we ask you to consider whether it really is in the long-term interest of the average taxpayer to force the Internal Revenue Service to administer and enforce the tax laws with this impediment? Because of the negative impact on fairness, privacy and efficiency, the answer to this question is clearly no.

Although Treasury has not formally estimated the cost of this proposal, it is almost certain to be very large. The trust of law-abiding citizens who do comply with the tax laws would be eroded.

Moreover, this provision is likely to result in significant increases in reporting and recordkeeping burdens on the public because the IRS will be forced to obtain more information concerning taxpayers from third parties to carry the burden of proof. Not only will this be extremely costly, but it directly conflicts with our goal of reducing reporting and recordkeeping burdens wherever possible.

In sum, this proposal could severely weaken, if not destroy, our voluntary compliance system as we know it today.

* * *

I would also like to comment briefly on the remaining two provisions in H.R. 390.

§ 2. Secretary of the Treasury Required to Specify, on Request, Regulations Implementing Specific Taxes

Current law. Under current law, the IRS provides taxpayers with an explanation of the bases for its proposed adjustments in its statutory notices and provides detailed citations to authorities in support of its position in field audits.

Proposal. Section 2 of H.R. 390 would obligate the Secretary to provide each person who was made liable for a tax, upon written request, with a written identification of the type of tax and regulations relating to the adjustment. This written identification would have to be provided within 14 days of the request.

Discussion. We agree taxpayers should be made aware of the basis for an adjustment. In fact, this information is routinely provided by the IRS and already is available on request of the taxpayer. However, we question whether forcing a response in all cases within 14 days, regardless of the posture of the case, that could consume significant resources, would result in a commensurate benefit to taxpayers.

§ 3. Increase in Limit on Recovery of Civil Damages for Unauthorized Collection Actions; Exclusion of Such Damages From Income

Current law. Under current law, if an officer or employee of the IRS recklessly or intentionally disregards a provision of the Internal Revenue Code or Treasury regulations, the affected taxpayer may sue the United States for the lesser of (i) $100,000 and (ii) direct economic damages plus costs.

Proposal. The bill would increase the damage cap to $1 million and exclude the damages from the taxpayer's income.

Discussion. We believe that the current statutory provision strikes a reasonable balance between safeguarding the interests of taxpayers and the IRS. We are concerned that increasing the damage cap to $1 million could significantly encourage lawsuits by tax protestors. Excluding damages from income also results in mismeasurement of a taxpayer's economic income and is an indirect way of raising the cap.

II. TAXPAYER BILL OF RIGHTS 2

The Treasury and the IRS worked closely with Members of Congress and their staffs in developing the 1988 Taxpayer Bill of Rights legislation, and we are continuing to meet with Congressional staffs to develop new ideas that will build upon the advances that already have been made. Commissioner Richardson, who will testify after me, will set forth some of the ideas that the IRS and Treasury are developing.

As a general policy matter, the Administration has and will support legislative and regulatory proposals for procedural changes that are well-defined and that improve the tax system, subject of course to budget neutrality requirements that must be satisfied.

We also caution against attempting to codify existing IRS practices and procedures. This may hamper the ability of the IRS to revise those rules to respond to changed circumstances and encourage a small segment of the taxpayer community to engage in unproductive litigation that consumes scarce IRS resources. The costs of the delays and litigation expenses generally must be borne ultimately by all taxpayers.

The remainder of my testimony comments on specific provisions of the "Taxpayer Bill of Rights Two" (TBOR 2) bills.

The two versions of TBOR 2 that are the focus of this hearing (H.R. 661 and H.R. 11) are very similar in most respects. We support many of the provisions in their current form or with minor modifications that we have been discussing with Congressional staffs. At the current time, we understand that there are roughly 40 sections in each of the current bills and we have major disagreements with only a small number of these provisions. We are supportive, for example, of proposals in each of these bills to (1) extend the interest-free period for payment of tax after notice and demand; (2) disclose collection activities against spouses who filed a joint return; (3) permit joint returns after separate returns without immediate full payment of tax; (4) include phone numbers on payee statements; (5) apply the failure-to-pay penalty evenly to regular and substitute returns; and (6) make reasonable efforts to notify taxpayers that have made payments the IRS cannot associate with any tax liability.

Commissioner Richardson will testify in more detail on some new ideas that have been suggested. I would like to focus the balance of my testimony on our points of disagreement with the bills.

Taxpayer Advocate

§ 101 of H.R. 661 and S. 258 (same in pertinent part as § 5001 of H.R. 11). Establishment of Position of Taxpayer Advocate within the IRS

Both H.R. 661 and H.R. 11 contain two sections that affect the office of the Taxpayer Ombudsman. I generally will defer on these provisions to Lee Monks, the current Ombudsman. However, there are two issues on which I would like to comment.

Current law. Under current law, the Administration's tax legislative initiatives are not presented to Congress until they are cleared by all pertinent executive offices and agencies, including the Office of Tax Policy, the Internal Revenue Service, and the Office of Management and Budget. The Ombudsman is appointed by the Commissioner.

Proposal. Section 101 of H.R. 661 and section 5001 of H.R. 11 require the Ombudsman (who would be renamed the Taxpayer Advocate) to submit an annual report to the tax-writing committees on the activities of his office. Each such report would have to contain recommendations for legislative solutions to problems encountered by taxpayers. These reports would not be permitted to be reviewed by officials of Treasury, IRS, or the Office of Management and Budget, including the Commissioner and the Assistant Secretary for Tax Policy, prior to being submitted to Congress.

Section 5001 of H.R. 11, unlike section 101 of H.R. 661, requires the Taxpayer Advocate to be appointed by the President and confirmed by the Senate.

Discussion. We believe that the Ombudsman (or Taxpayer Advocate) should be independent and free to discuss his views, and we are pleased that the current bill does not contain a mandate that he be chosen by the President and confirmed by the Senate. But we draw the line at submitting legislative proposals in the absence of review by other offices. We believe that the Administration should speak with one voice on tax legislative proposals, taking into account the priorities of the Administration, the views of the Secretary of the Treasury, the concerns of many agencies and the technical, revenue estimating and policy input of the Office of Tax Policy and administrative input of the IRS. In short, we believe this provision undercuts the right of the Executive branch to present to Congress a balanced fiscal and economic agenda and the role of the Secretary of the Treasury as the spokesman of the Administration's fiscal matters.

Installment Agreements

§ 202 of H.R. 661 and S. 258 (not in H.R. 11). Running of Failure-to-Pay Penalty Suspended during Period Installment Agreement is in Effect

Current law. Under current law, taxpayers generally must pay interest and a failure-to-pay penalty on taxes that are not paid on time. The failure-to-pay penalty applies during the period of time an installment agreement is in effect.

Proposal. The proposal would suspend the failure-to-pay penalty during the period of time an installment agreement is in effect, as long as the agreement was requested before the due date of the return.

Discussion. This proposal would have a serious negative impact on revenues and collections. Taxpayers who otherwise could pay taxes on time would be encouraged to pay in installments. Consider the interest arbitrage between the rate of interest on payments to the Federal government and the rate of interest for credit card borrowings. The government rate is only about half the credit card rate. Obviously, anyone with credit card balances should pay that first before paying tax. Also, if the rate of interest owed the government is less than the return taxpayers could earn by investing the delayed payments, taxpayers would have an incentive to borrow from the government by not paying tax on time. The consequences of the proposal would be exacerbated when combined with the proposal (section 201 of H.R. 661 and S. 258) permitting installment agreements as a matter of right.

Interest

§ 301 of H.R. 661 and S. 258 (modification of § 5201 of H.R. 11). Expansion of Authority to Abate Interest

Current law. Under current law, the IRS has the authority to abate interest assessed with respect to a tax deficiency or payment that is attributable to the error by, or delay of, an IRS employee performing a "ministerial" act.

Proposal. In the case of taxpayers with net worth and size exceeding certain thresholds (generally, $2 million for individuals and $7 million or 500 employees for businesses), the IRS would be authorized to refund or abate interest attributable to "unreasonable" IRS errors or delays, regardless of whether the error was attributable to a "ministerial" act. In the case of taxpayers with a net worth and size below the thresholds, the IRS would be obligated to abate the interest until the demand for payment was made. The counterpart to this proposal in H.R. 11 omits the net worth distinction and does not mandate abatement for any taxpayers.

Discussion. This broadening of the authority to abate interest in both H.R. 661 and H.R. 11 would encourage taxpayers to seek relief from interest assessments as a matter of course, imposing significant administrative and controversy-related costs on the IRS. These costs ultimately would be borne by all taxpayers. In addition the vagueness of the standard for abatement would lead to uneven application of the law.

Moreover, even during delays in the resolution of an issue, taxpayers have the use of government money. Since interest (unlike a penalty) is compensation for the use of money, the provision would represent an economic windfall to taxpayers in many cases.

The net worth distinction in H.R. 661 lacks a solid policy foundation as it is unrelated to the purpose of an interest charge, which is to account for the time value of money. When coupled with the mandatory abatement for "small" taxpayers, the proposal also would have a negative impact on tax revenues. We also believe that the net worth distinction would add significant administrative complexity.

Information Returns

§ 603 of H.R. 661 and S. 258 (modification of § 5503 of H.R. 11). Requirement to Conduct Reasonable Investigations of Information Returns

Current law. Deficiencies determined by the IRS generally are afforded a presumption of correctness.

Proposal. Section 603 of H.R. 661 would place the burden of proof on the IRS in all reasonable disputes concerning the accuracy of income reported on an information return filed by a third party, unless the IRS had conducted a reasonable investigation of the accuracy of the return. The proposal is more expansive than its counterpart in H.R. 11. Section 5503 of H.R. 11 is limited to disputes over information returns in court proceedings, does not apply unless the taxpayers cooperate, and requires the IRS to present "reasonable and probative information" concerning the deficiency, rather than to shoulder the burden of proof.

Discussion. We believe the H.R. 11 proposal strikes an acceptable balance between taxpayer and government burdens. The IRS already has updated its procedures to incorporate the substance of that proposal.

For many of the reasons discussed in our comments on section 1 of H.R. 390, we have very serious misgivings about the version of this proposal in H.R. 661. By shifting the burden of proof on income reported on information returns to the IRS, the H.R. 661 proposal could eviscerate the IRS's matching program by eliminating the presumption of correctness if the IRS failed to physically examine the return or otherwise conduct a "reasonable investigation" of the return's accuracy. Taxpayers, without presenting any supporting evidence, could force the IRS to investigate the accuracy of information returns before issuing notices of deficiency.

Any statutory change that prevents the IRS from asserting deficiencies on the basis of information returns could have devastating effects on the tax compliance system and profoundly increase the resource needs of the IRS. Computerized matching of information returns has had a significant positive impact on taxpayer compliance. This change would represent a significant step backwards.

Administrative Costs

§ 804 of H.R. 661 and S. 258 (not in H.R. 11). Authority for Court to Award Reasonable Administrative Costs

Current law. Under current law, a "prevailing party" in an administrative or judicial proceeding is entitled to reasonable litigation and administrative costs, including attorneys' fees. Positions of the IRS taken prior to issuance of an IRS Appeals decision or notice of deficiency are not taken into account.

Proposal. Although the drafting of the proposal is not entirely clear, its intent appears to be to permit taxpayers to recover costs in connection with IRS positions asserted prior to an IRS Appeals decision or notice of deficiency.

Discussion. Cost recoveries should be allowed only after the United States has adopted a litigating position. The position of the United States during the early stages of an investigation cannot be judged against the "substantial justification" standard used to determine if one is a prevailing party, because examining agents pursue fact-finding investigations that do not consider the hazards of litigation.

Relief from Retroactive Regulations

§ 903 of H.R. 661 and S. 258 (modification of § 5803 of H.R. 11). Relief from Retroactive Application of Treasury Regulations

Current law. A taxpayer may rely on Treasury regulations and revenue rulings that accord with the taxpayer's particular facts. In addition, penalties are abated for taxpayers who rely on other written guidance of the IRS. The Secretary may exercise its discretion to issue tax regulations prospectively or retroactively.

Proposal. With a few exceptions, section 903 of H.R. 661 and the corollary provision in H.R. 11, would prohibit final regulations from applying to a taxable period ending before the earlier of (1) the date related proposed regulations were filed with the Federal Register; or (2) a Notice was issued substantially describing the expected content of the regulations. Under both sections, regulations could apply to an earlier period (1) to prevent abuse of a statute, (2) to cure procedural defects in previously issued regulations, or (3) pursuant to an election by the taxpayer. The H.R. 11 version provides an additional very important exception. Under H.R. 11, regulations issued within 12 months of the date of enactment of a statute may relate back to that date. Both H.R. 661 and H.R. 11 would apply retroactively to invalidate regulations that already have been issued.

Discussion. Section 7805(b) of the Internal Revenue Code, in existence basically since 1921, confers broad authority on Treasury to authorize prospective effective dates for rulings, regulations and other types of guidance. It presumes that regulations can always be applied retroactively. However, in practice, Treasury rarely has applied guidance retroactively unless the taxpayers have wanted retroactive treatment. Most reviews, some of them rather extensive, by academics, bar associations and practitioners, have concluded that Treasury has acted responsibly and reasonably. We are not aware of comments suggesting a pattern of misuse or other emergency justifying the type of fundamental change contemplated by the proposal.

The ban would encourage aggressive return positions for transactions that occur in the "window" between the date of change in the statute and the date of issuance of regulations interpreting that change. Taxpayers would routinely litigate the new nonproductive question of whether a retroactive regulation was justified, because their transaction "abused" the statute. In addition, the exception for retroactive regulations to curb abuse of a statute would not cover regulations addressing judicial decisions or substantive defects in prior regulations. The absence of an exception in H.R. 661 for regulations issued within twelve months of the related statutory provision would inhibit the ability of Treasury to implement the operation of new legislation according to Congressional intent. Taxpayers would constantly "race" the Treasury to complete their questionable transactions before regulations could be issued.

Finally, the retroactive effective date of the proposal is, at best, counterproductive. By applying to regulations filed on or after January 5, 1993, the proposal in H.R. 661 would undercut legitimate taxpayer reliance on regulations issued on or after that date and before H.R. 661 was enacted.

* * *

This concludes my prepared remarks. I will remain to answer any questions that you have after the Commissioner's and the Ombudsman's statements. Thank you.

Chairman JOHNSON. Thank you, Ms. Beerbower. .
Ms. Richardson, welcome.

STATEMENT OF MARGARET MILNER RICHARDSON, COMMISSIONER, INTERNAL REVENUE SERVICE

Ms. RICHARDSON. Thank you, Madam Chairman and other distinguished members of this committee. I have a longer written statement which I would like to submit for the record and then summarize it, if I might.

I appreciate the opportunity to be able to testify today before this subcommittee on the possible development of a Taxpayer Bill of Rights II. The issue that we are discussing today, ensuring that the rights of American taxpayers are protected, is of the greatest importance to me, to the Internal Revenue Service, and to American taxpayers.

With me today is Lee Monks, the Taxpayer Ombudsman, who will speak to you from his perspective as a taxpayer advocate.

I want to begin today by assuring you that the Internal Revenue Service is committed to respecting the rights of all taxpayers. Although I believe that we have the best tax administration system in the world, that does not mean that we should not continue to improve it. Our tax system, with the rights afforded taxpayers under it, is the model to which other nations look both in planning their systems and in measuring their successes.

Since becoming Commissioner almost 2 years ago, I have had the opportunity to visit with many of our almost 115,000 employees. What has particularly impressed me has been their dedication to and concern for protecting taxpayers' rights and their commitment to reaching balanced, sensible solutions to the varied and often unique taxpayer situations with which they are confronted. The vast majority of our employees care very deeply about providing good customer service and about protecting taxpayers' rights.

I think we have long recognized that there is an interrelationship between taxpayer service and taxpayer rights. We understand that when we make it easier for taxpayers to meet their filing responsibilities, when we are helpful in assisting them with their questions, and when we more quickly respond to an account inquiry or problem, the more likely it is that they will feel respected and, in reality, have their rights respected.

Our commitment to providing good quality service to every taxpayer does run deep in our organization, and we are working very hard to break down the functional areas so that every employee, not just those who are officially assigned to the Taxpayer Service area, appreciates the importance we attach to taxpayer service and taxpayer rights.

But despite our progress, I believe that by working together we—Congress, the Treasury Department, and the IRS—really can still do more to enhance taxpayers' rights. There are, as Ms. Beerbower mentioned, significant areas of agreement about what provisions would further enhance taxpayers' rights, and I won't go into those. But we have detailed them in an appendix to my written testimony.

I would like to share with you today several new proposals that we believe will further enhance the rights of taxpayers. The first

proposal would assist the IRS in safeguarding each taxpayer's right to privacy. Protecting taxpayers' rights of privacy is a top priority for the Internal Revenue Service. I have repeatedly stated that we will not tolerate any violation by employees of taxpayers' rights of privacy. Taxpayers' confidence that their privacy rights will be honored and that their tax return information will be kept confidential is one of the foundations of our voluntary compliance system.

A basic tenet of our confidentiality and privacy policy is a prohibition against employee access to or use of tax return information, except when it is essential for that employee to perform his or her assigned function. Our proposal, which we hope you will support, provides specific criminal sanctions that would apply to employees who violate this policy.

Under another proposal we have made, the IRS would be required to abate a penalty assessed for the first time a taxpayer failed to make the required deposits of payroll taxes if: that failure occurred during the first quarter that wages were paid; the return was filed on time and appropriate payments were made; and the taxpayer completes an IRS-approved education program that addresses the filing and payment requirements. This relief is aimed typically at new small business employers.

Finally, we propose a requirement that we issue annual reminders to taxpayers with outstanding delinquent accounts that are not in an active collection status, which remind taxpayers about the status of their accounts, the continued accrual of interest and penalties, and the continued possibility of having their refunds offset to pay those outstanding amounts.

Madam Chairman, we would like to assist your subcommittee in making these proposals a reality. We would also like to work closely with the Treasury Department and the subcommittee as you all consider various proposals so that we can inform you about the provisions we believe would propose significant administrability issues. Some of the provisions raise issues that should be considered and balanced against the additional burden and appearance of inequity that they would cause.

One example is a provision to require income tax return instructions to contain information on installment agreements, extensions of time to pay, and offers in compromise. We believe that by promoting the availability of offers in compromise before returns are filed and taxes are due through references in the income tax instructions, there is a risk of undermining the confidence of the overwhelming majority of taxpayers who timely and fully pay their liabilities. It is issues of this nature, balancing the rights of taxpayers who do pay fully and on time against the rights of those who may make an offer to settle their liabilities for an amount significantly lower than the amount they owe, that are ones we hope the subcommittee will explore with us further as it considers the legislation.

We also hope to work with you to give you an appreciation of some of the resource issues presented by the proposals, as well as some of the technological constraints that make some of the proposals infeasible with our current systems.

In the interest of time, I only want to discuss a few of the administrative concerns we have with the proposals considered today,

but, again, outlined in my index are a number of concerns that we have about some of the proposals.

Although the taxpayer ombudsman is going to address the organization and responsibilities of his function and a proposal to expand its authority to issue taxpayer assistance orders, I wanted to share with you how the ombudsman and his organization have had a positive impact on the promotion of taxpayer rights within the IRS.

Not only does the ombudsman and his organization assist taxpayers individually through the Problem Resolution Program, he also provides recommendations to improve the quality of IRS programs and systems that benefit all taxpayers. Through these recommendations for systemic changes, the ombudsman has a much wider impact than if his only contribution were to address taxpayers' problems individually.

Currently, problem resolution officers in the Service centers and district offices report to the heads of these offices. This organizational structure provides a strong incentive for these field offices to deliver quality services to taxpayers and promptly resolve taxpayer problems. It also allows problems that occur at the local level to be resolved at the local level.

The current structure, by all accounts, is working well. There is a proposal in some of the legislation to remove problem resolution officers from the current management reporting lines and have them report to the ombudsman in Washington, D.C. Madam Chairman, I encourage the subcommittee and your staff to explore with the ombudsman and his staff the effect that such a change would have on their ability to help taxpayers. Any change should be carefully considered and not just done for the sake of change.

We are also concerned with provisions that generally give noncorporate taxpayers the automatic right to installment agreements once every 3 years and eliminate failure-to-pay penalties for taxpayers who request installment agreements by the due dates for payment of their taxes. Rather than enhancing taxpayers' rights, these automatic installment agreements, with no failure-to-pay penalties, would be unfair to the vast majority of taxpayers who do pay their taxes on time.

Another proposal would expand the IRS' authority to abate interest assessments by replacing the "error or delay in performing a ministerial act" standard for abatement with an "unreasonable error or delay" standard. It would also require the IRS to abate interest assessments against small businesses and most individuals in cases of "unreasonable error or delay," but only until the date that the demand for payment is made. The apparent justification for this proposal——

Chairman JOHNSON. Excuse me, Commissioner. Could you come a little closer to the microphone?

Ms. RICHARDSON. I am sorry.

Chairman JOHNSON. Gradually, I think we are all having more trouble hearing.

Ms. RICHARDSON. The apparent justification for this proposal—that a taxpayer who has an unpaid tax liability and is charged interest on that unpaid liability is somehow economically disadvan-

taged relative to a taxpayer who timely paid his or her liability without interest—is one with which we do not agree.

This broadening of the interest abatement standard would encourage taxpayers, particularly those with large liabilities, to seek routine relief from interest assessments, thereby imposing significant administrative costs, as well as controversy-related costs, on the IRS and the judicial system. These costs ultimately would be borne by all taxpayers.

Another proposal would require the IRS, prior to commencing an examination, to notify a taxpayer in writing of a planned examination and the examination procedures, with exceptions which apply for criminal investigations, collection jeopardy situations, national security needs, and confidential law enforcement. In many respects——

Chairman JOHNSON. Excuse me, Commissioner. You do have to practically have the microphone right in your face. Thank you.

Ms. RICHARDSON. In many respects, this provision is consistent with our current procedures. For example, we generally provide written notice and a copy of Publication 1, "Your Rights as a Taxpayer," prior to commencing an examination. This provision requiring advance notice, however, would undermine some compliance efforts, including roadside inspections of highway vehicles to ensure they are not evading Federal motor fuel excise taxes, compliance checks for currency transaction reporting, and unannounced visits to electronic return originators to determine whether they are complying with our procedures.

Our current document matching program is an efficient, cost-effective way to stop underreporting of income. We experience an overall compliance rate of over 95 percent in the areas for which we have information reporting. Under the document matching, we match information documents, such as forms 1099 received from third parties, against filed income tax returns. Underreported amounts become subject to correspondence audits.

I am greatly concerned about the provision in H.R. 661 and S. 258 that would shift the burden of proof to the IRS for income reported on information returns. Taxpayers, without presenting any supporting evidence, could force the IRS to investigate the accuracy of information returns before issuing notices of deficiency. We believe this proposal would render the IRS' matching program inoperable. Without this program, the IRS would need substantial additional resources to reach the same level of compliance with the tax laws that we have today.

An H.R. 11 proposal to reform the Service's information reporting procedures provided the same standards as those currently in the Internal Revenue Manual. The H.R. 11 proposal reflected the joint effort of the Service and Treasury, working with Congress, to respond to the concern underlying both that proposal and the H.R. 661 and S. 258 proposal. We believe that that proposal in H.R. 11 strikes a reasonable and appropriate balance between the rights and obligations of both taxpayers and the Government.

I would like now to turn to H.R. 390. H.R. 390 contains a provision that would shift the burden of proof to the IRS during any court proceedings. Madam Chairman, not only would that provision undermine the Federal income tax system, but also State tax sys-

tems that depend on Federal deficiency assessments, assessments which would simply evaporate if this provision were enacted.

The current burden of proof rules have been in place for well over a century and are closely woven into the fabric of our system of voluntary compliance. While proposals to shift the burden of proof to the Government have been advanced during this period, in each instance the proposals have been rejected. The reasons for rejection were well stated during a 1925 debate on a proposal that, like H.R. 390, would have placed the burden of proof on the Government. The quote went as follows:

> You might as well repeal the income tax law and pass the hat, because you will be practically saying to the taxpayer, How much do you want to contribute toward the support of the government? And in that case they would have to decide for themselves.

The Internal Revenue Code and the administrative policies of the IRS contain many procedures designed to foster the administrative settlement of civil tax disputes and result in the successful resolution of the vast majority of the civil disputes that arise under the tax laws. Not all disputes can be resolved administratively, however, and the code permits taxpayers dissatisfied with the outcome of these administrative proceedings to seek relief in court.

Throughout the history of tax litigation in this country, the taxpayer has been required to bear the burden of proof in tax disputes. This allocation of the burden of proof is in keeping with the common law traditions, is sensible and fair, and reflects some of the fundamental principles that underlie our system of taxation.

Generally, in civil tax litigation, the burden of proof is on the taxpayer. In those situations where liability is imposed for civil fraud or where there is alleged criminal liability, the burden of proof is on the Government—a situation that, for good reason, should continue.

But there are good reasons not to change the burden of proof in civil tax litigation. First, as I said, the current rules are consistent with the voluntary self-assessment system, which presumes that taxpayers, and not the Government, are best able to maintain and produce records to substantiate items on their tax returns.

Second, placing the litigation burden of proof on taxpayers promotes administrative resolution of tax cases. Knowledge of this ultimate burden provides an incentive for them to voluntarily produce information during an audit and subsequent administrative proceedings.

Third, taxpayers, like other claimants, should bear the burden of proving their claims in court. Under the common law, parties challenging administratively proper decisions of Government agencies are typically required to shoulder the burden of proof. The Internal Revenue Code and current administrative practices of the Internal Revenue Service ensure that taxpayers have many opportunities to seek resolution of tax disputes short of litigation.

Finally, considerations of fairness and efficiency require that taxpayers bear the burden of proof. The common law generally places the burden of proof on the party with the most ready access to the evidence necessary to adjudicate claims. This common law tradition is not only consistent with principles of fairness, it substantially

lessens the need for court-supervised and intrusive discovery during both administrative and court proceedings.

Also, it is unrealistic to expect that the Government has either the resources or the ability to prove that all taxpayer claims, no matter how outlandish, are false. I think that Ms. Beerbower touched on a number of the issues and concerns. I won't go into that here.

Chairman JOHNSON. She did. And I think if you could skip over those parts of your testimony——

Ms. RICHARDSON. Except to say that we believe that H.R. 390 would not serve in the best interests of sound tax administration and the American taxpayer. Taxpayers would be encouraged to keep or produce nothing about their tax affairs and require the Government to disprove every item on their return. Recordless taxpayers, including those who earn income from illegal sources, would be rewarded.

Passage of H.R. 390 would also necessitate additional information gathering by and reporting to the Government. Audits performed with the burden of proof on the Service would involve a much broader and more detailed inspection of the financial affairs of the taxpayer and third parties. Rather than simply choosing certain items on a taxpayer's return to review according to specific enforcement criteria, which we do today, the Service would, of necessity, need to challenge a greater number of items. The audits would be much more costly to the——

Chairman JOHNSON. Commissioner, if I may interrupt you for a minute. Since the Treasury did go into this in detail, I think if we could skip forward, since there is so much to cover this morning, I would appreciate it.

Ms. RICHARDSON. OK. Finally, I guess the final point we want to make is that court proceedings would also be burdened by the rule change because the only response the Government could make to shifting the burden would be to increase the amount of discovery in litigation.

We think that you will hear from a number of other sources also, Madam Chairman, who are interested in sound tax administration, that passage of H.R. 390 would in effect destroy our voluntary compliance system.

You also asked for our views as to how to best enhance taxpayer rights. In today's dynamic service-oriented business environment, taxpayers have come to expect prompt access to information and assistance with account inquiries and problems, the type of access and assistance they receive in the private sector. Unfortunately, however, as you know all too well, we simply cannot deliver this level of service with our 30-year-old technology. Only through modernization of our information systems will we be able to successfully meet the demands of taxpayers and provide taxpayer rights. Therefore, I am asking that this committee assist us in obtaining the tools we need to properly serve our customers by ensuring full and stable funding for our Tax Systems Modernization Program.

I would like to close with a simple yet, I think, very poignant illustration of the types of things that tax systems modernization would enable us to do for the cause of taxpayer rights. Earlier, we discussed concerns about a proposal to expand our authority to

abate interest assessments and to require us to abate interest assessments in certain cases. But what if we eliminate the need for these interest assessments in the first place without exposing the tax system to the problems presented by the interest abatement proposal?

Tax systems modernization holds the key to providing drastic reductions in the amount of interest assessed to taxpayers. When TSM is fully implemented with its online capabilities, our goal is to match information documents at the time a return is filed, not almost 2 years later, as is done today. That means that almost 2 years' worth of interest assessments could be eliminated for every taxpayer with an unpaid tax balance that is detected through our information document matching programs. TSM will also reduce errors, reduce the time it takes to begin and conduct examinations, speed up account problem resolution for taxpayers, and accelerate collection activities, thus providing further opportunities for reductions in the amount of interest assessments.

With TSM fully implemented, systemic improvements will be possible that would improve the efficiency of the Government, benefit all taxpayers, and result in significant interest assessment reductions.

We are already beginning to reap many of the benefits of TSM today, but we need your assistance to bring it to full and successful completion. Madam Chairman, I am committed to an IRS that expects no less than that all of its employees are advocates for taxpayers, while at the same time ensuring that taxpayers who are compliant with the tax laws are not disillusioned by those who use procedural loopholes to game the system.

I would like to thank you and your colleagues for the opportunity to provide our views in this important area, and we look forward to working with you on the proposals. I will be happy to answer questions after Mr. Monks testifies.

[The prepared statement and attachment follow:]

STATEMENT OF

MARGARET MILNER RICHARDSON
COMMISSIONER OF INTERNAL REVENUE

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT
HOUSE COMMITTEE ON WAYS & MEANS

MARCH 24, 1995

Madame Chairman and Distinguished Members of the Subcommittee:

I appreciate the opportunity to testify today before this Subcommittee on the possible development of a Taxpayer Bill of Rights 2 (TBOR2) and on specific proposals in H.R. 11 from the 102nd Congress ("H.R. 11") and H.R. 390, H.R. 661, and S. 258 as introduced in this Congress. The issue we will be discussing today -- ensuring that the rights of American taxpayers are protected -- is of the greatest importance to me, the Internal Revenue Service, and American taxpayers. One of my most important responsibilities as Commissioner of Internal Revenue is to ensure that, in dealings with the IRS, taxpayers are treated fairly, courteously, and with respect and dignity.

With me today is Lee Monks, the Taxpayer Ombudsman. The position of Ombudsman was created by the Internal Revenue Service in 1979. Since that time, the Ombudsman has served taxpayers well and has made countless improvements in the ways that the IRS interacts with taxpayers. The Ombudsman has also successfully carried out the purposes of the Taxpayer Bill of Rights since its enactment in 1988. Mr. Monks will speak to you today from his perspective as an advocate for taxpayers.

I want to begin today by assuring you that the Internal Revenue Service is committed to respecting the rights of all taxpayers. I believe that we have the best tax administration system in the world, although that does not mean that we should not continue to improve it. Our tax system, with the rights afforded taxpayers under it, is the model to which other nations look both in planning their systems and in measuring their successes.

Since becoming Commissioner almost two years ago, I have had the opportunity to visit with many of our almost 115,000 employees. What has particularly impressed me has been their dedication to and concern for protecting taxpayers' rights and their commitment to reaching balanced, sensible solutions to the varied and often unique taxpayer situations with which they are confronted. Contrary to what is often, in my experience, a very distorted stereotype, the vast majority of our employees care very deeply about providing good customer service and protecting taxpayers' rights.

I realize that there will always be isolated instances in which individual IRS employees have made mistakes. I also realize that given the size of our organization, the volume of our business, and the number of contacts we have with taxpayers each year, the "giant" metaphors like the one in the Subcommittee's press release are simply irresistible. My hope, however, is that the overwhelming number of taxpayers who come in contact with us will come to know us as a genteel, Gulliver-like giant, rather than the Goliath referred to in the Subcommittee's press release.

TAXPAYER SERVICE AND TAXPAYER RIGHTS

In recent years, the Service has made great strides in focusing on customer service. We have long recognized the interrelationship of taxpayer service and taxpayer rights. The better we serve taxpayers -- the easier we make it for them to

meet their filing responsibilities, the more helpful we are in assisting them with their questions, and the more quickly we can respond to an account inquiry or problem -- the more likely it is that they will feel their rights have been respected. Our commitment to providing quality service to every taxpayer runs deep in our organization. By breaking down functional barriers of the past, we are trying to ensure that every employee -- not just those under the direction of the Assistant Commissioner (Taxpayer Services) -- appreciates the importance we attach to both taxpayer service and taxpayer rights.

Our strong commitment to customer service and taxpayer rights is also evidenced by our Compliance 2000 program. Our Compliance 2000 philosophy recognizes that taxpayers cannot comply with the tax laws unless they understand their rights and obligations under those laws. This recognition of our need to serve taxpayers on the front end through education and outreach is intended to ensure that they have every opportunity to comply. Through this approach, enforcement efforts are reserved for only those cases where education and outreach are not successful. As with our other taxpayer service endeavors, to the extent we are successful in reaching out to taxpayers under our Compliance 2000 program, the more likely they will appreciate our commitment to the cause of taxpayer rights.

COMMON GROUND AND NEW IDEAS

Despite the progress we have made in providing better customer service and enhancing taxpayers' rights, I believe that, by working together, we -- Congress, the Treasury Department, and the IRS -- can do still more to enhance taxpayers' rights. There are significant areas of agreement between the IRS and the H.R. 11, H.R. 661, and S. 258 sponsors about what provisions would further enhance taxpayers' rights. Proposals to extend the interest-free period for payment of tax after notice and demand from 10 to 21 days, permit disclosure of collection activities among spouses or former spouses who filed a joint return, permit joint return filings without full payment of tax after an initial filing of separate returns, and require information returns to include the telephone number of the payor's information contact, for example, all represent sound ideas that would help to make the tax system fairer and more administrable. (I have provided a more detailed discussion of these provisions and others in H.R. 661 and S. 258, in the attached Appendix.)

The Treasury Department and the IRS worked closely with Congress both toward the enactment of Taxpayer Bill of Rights legislation in 1988 and the development of the taxpayer protection provisions which were included in H.R. 11. In fact, many of the provisions in H.R. 11, H.R. 661, and S. 258 were suggested to Congress by the IRS. But I would like to share with you today several new proposals that we believe will further enhance the rights of taxpayers. The first proposal is one that addresses a concern that I have heard about in almost every meeting I have had with tax practitioners over the past two years. Under current law, taxpayers cannot have their representatives resolve issues presented in IRS notices without providing the IRS with written authorizations to disclose the taxpayers' return information to the representatives -- often a time consuming process that delays the resolution of the taxpayers' issues.

Our proposal would eliminate such delays. It represents a careful balance between the security of taxpayer data and the need to be responsive to taxpayers' desires for quick resolution of their cases. Our proposal would provide taxpayers with an alternative to the written consent requirement. Instead, we

propose that a unique identifying number be included on each IRS notice. A taxpayer could give that notice's unique identification number to its authorized representative, which would permit the representative to deal directly with the IRS without delay.

The second proposal would assist the IRS in safeguarding each taxpayer's right to privacy. I have made protecting taxpayers' rights of privacy a top priority for the IRS. I have repeatedly stated that the IRS will not tolerate any violation by employees of taxpayers' rights of privacy. Taxpayers' confidence that their privacy rights will be honored and that their tax return information will be kept confidential is one of the foundations of our voluntary compliance system. I have adopted more severe administrative sanctions, up to and including dismissal, for employees who violate our policy concerning confidentiality and privacy. A basic tenet of that policy is a prohibition against employee access to (or use of) tax return information, except to the extent essential for the employee to perform his or her assigned functions. Our second proposal, which I request you support, provides specific criminal sanctions that would apply to employees who violate this policy.

Under our third proposal, the IRS would be required to abate a penalty assessed for the first time a taxpayer failed to make required deposits of payroll taxes if: (1) the failure occured during the first quarter wages were paid; (2) the return was filed on time and appropriate payments were made; and (3) the taxpayer completes an IRS-approved education program that addresses filing and payment requirements. This relief is consistent with the Compliance 2000 philosophy that I outlined earlier and is aimed at new (typically small business) employers.

Finally, and consistent with our efforts to assist taxpayers in meeting their obligations, we propose a requirement that we issue annual reminders to taxpayers with outstanding delinquent accounts that are not in an active collection status (i.e., accounts for which we are no longer issuing collection notices and that we consider currently not collectible). These notices would remind taxpayers about the status of their accounts, the continued accrual of interest and penalties, and the continued possibility of having their refunds offset to pay the outstanding amounts.

Madame Chairman, I hope that these proposals for enhancing taxpayers' rights will be seriously considered by the Subcommittee. The IRS and the Treasury Department would like to assist the Subcommittee in making them a reality and in identifying appropriate offsets, as necessary, to ensure they are implemented in a deficit neutral manner.

AREAS OF CONCERN FOR TAX ADMINISTRATION

The IRS and the Treasury Department also would like to work closely with the Subcommittee as it considers H.R. 11, H.R. 661, S. 258, and H.R. 390 so that we can inform you about those provisions we believe would pose significant administrability issues. Some of the provisions raise issues that should be considered and balanced against the additional burden and appearance of inequity they could cause before the Subcommittee recommends legislation. One example is in section 5901 of H.R. 11 and section 1001 of H.R. 661 and S. 258. Those sections would require the income tax return instructions to contain information on installment agreements, extensions of time to pay, and offers in compromise.

Offers in compromise, for example, represent a delicate balance between the need to ensure that taxpayers are treated consistently and fairly and the need to ensure that the government will be able to collect at least a portion of an

insolvent (or close to insolvent) taxpayer's debt. By promoting the availability of offers in compromise before returns are filed and taxes are due through references in the income tax return instructions, there is a risk of undermining the confidence of the overwhelming majority of taxpayers who timely and fully pay their determined liabilities. Issues of this nature -- balancing the rights of taxpayers who pay fully and on time against the rights of those who may make an offer to settle their liabilities for an amount significantly lower than the amount that they owe -- are ones we hope the Subcommittee will explore with us further as it considers the legislation. We also hope to work with you to give you an appreciation of some of the resource issues presented by the proposals, as well as some of the technological constraints that make some of the proposals infeasible under our current systems.

In the interest of time, I will only discuss a few of our administrative concerns with the H.R. 11, H.R. 661, S. 258, and H.R. 390 proposals today. The Appendix to my testimony, however, outlines each of the provisions about which we have concerns. I would like to focus on the following proposals: (1) changing the Taxpayer Ombudsman's organization and responsibilities; (2) granting installment agreements as a matter of right to non-corporate taxpayers and eliminating failure-to-pay penalties for taxpayers that request an installment agreement by the due date for payment of their taxes; (3) expanding the IRS' authority to abate interest assessments and requiring the IRS to abate interest to certain taxpayers; (4) requiring the IRS to give advance notification of an examination; (5) shifting the burden of proof to the government in certain information report matching cases; and (6) shifting the burden of proof to the government in all tax matters. I will defer to the testimony of Cynthia Beerbower, Deputy Assistant Secretary (Tax Policy), on the importance of ensuring that the Treasury Department and the IRS retain the ability to issue retroactive regulations where appropriate in the interest of sound tax administration.

Taxpayer Ombudsman and Taxpayer Assistance Orders

While Lee Monks, the Taxpayer Ombudsman, will address the organization and responsibilities of the Taxpayer Ombudsman function and a proposal to expand its authority to issue Taxpayer Assistance Orders, I wanted to share with you how the Ombudsman and his organization have had a positive impact on the promotion of taxpayer rights within the IRS. Not only does the Ombudsman and his organization assist taxpayers individually through the problem resolution program, but the Ombudsman also provides recommendations to improve the quality of the IRS programs and systems that benefit all taxpayers. Through these recommendations for systemic changes, the Ombudsman has a much wider impact than if his only contribution were to address taxpayers' problems individually.

Currently, Problem Resolution Officers (PROs) in the Service Centers and District offices report to the heads of these offices. This organizational structure provides a strong incentive to these field offices to deliver quality services to taxpayers and promptly resolve taxpayer problems. It also allows problems that occur at the local level to be resolved at the local level. The current structure, by all accounts, is working well. Section 101 of H.R. 661 and S. 258, however, would remove PROs from the current management reporting lines and have them report to the Ombudsman in Washington, D.C. Madame Chairman, I encourage the Subcommittee to explore with the Ombudsman and his staff the effect that such a change would have on their ability to help taxpayers. Any change should be carefully considered and not be done just for the sake of change.

Installment Agreements and the Failure-to-Pay Penalty

H.R. 661 and S. 258 contain provisions that generally give non-corporate taxpayers the automatic right to installment agreements once every three years and eliminate failure-to-pay penalties for taxpayers who request installment agreements by the due dates for payment of their taxes. Rather than enhancing taxpayers' rights, this "automatic" installment agreement with no failure-to-pay penalties would be unfair to the vast majority of taxpayers who pay their taxes on time. Under the combined effects of these proposals: (1) all taxpayers would have every incentive not to timely pay and to borrow from the government at least once every three years at interest rates generally lower than prevailing market rates for unsecured debt; (2) the IRS would see a significant growth in its accounts receivable inventory (a topic of great concern to the IRS, Congress, and the GAO); (3) the IRS would have to shift substantial additional resources to intrusive, post-filing collection efforts; and (4) the revenue loss to the government would be substantial.

Abatement of Interest

Section 301 of H.R. 661 and S. 258 would expand the IRS' authority to abate interest assessments by replacing the "error or delay in performing a ministerial act" standard for abatement with an "unreasonable error or delay" standard. It would also require the IRS to abate interest assessments against small businesses and most individuals in cases of "unreasonable error or delay," but only until the date demand for payment is made. The apparent justification for this proposal -- that a taxpayer who has an unpaid tax liability and is charged interest on that unpaid liability is somehow economically disadvantaged relative to a taxpayer who timely paid its liability without interest -- is one with which we do not agree.

This broadening of the interest abatement standard would encourage taxpayers, particularly those with large liabilities, to seek routine relief from interest assessments, thereby imposing significant administrative costs, as well as controversy-related costs, on the IRS and the judicial system. These costs ultimately would be borne by all taxpayers. Additionally, the unreasonable error or delay standard is vague and, as such, would present significant challenges in ensuring consistent application of the law. Finally, "means testing" the requirement to abate interest by imposing a net worth requirement as the bill does is incompatible with the purpose of an interest charge and presents administrative complexity and additional burden on taxpayers if they are required to provide net worth data which would have to be verified.

Notification of Examination

Another section of H.R. 661 and S. 258 would require the IRS, prior to commencing an examination, to notify a taxpayer in writing of a planned examination and the examination procedures. Exceptions would apply for criminal investigations, collection jeopardy situations, national security needs, and confidential law enforcement or foreign counterintelligence activities. In many respects this provision is consistent with IRS' current procedures; for example, we generally provide written notice and a copy of Publication 1, "Your Rights as a Taxpayer," prior to commencing an examination. The provision requiring advance notice, however, would undermine some compliance efforts, including roadside inspections of highway vehicles to ensure they are not evading federal motor fuels excise taxes, compliance checks for currency transaction reporting, and unannounced visits to Electronic Return Originators to determine whether they are complying with IRS procedures.

Burden of Proof in Information Reporting Cases

Our current document matching program is an efficient, cost effective way to stop underreporting of income. We experience a overall compliance rate of over 95% in the areas for which we have information reporting. Under the document matching, we match information documents, such as Forms 1099 received from third parties, against filed income tax returns. Underreported amounts become subject to correspondence audits.

I am greatly concerned about the provision in H.R. 661 and S. 258 that would shift the burden of proof to the IRS for income reported on information returns. Taxpayers, without presenting any supporting evidence, could force the IRS to investigate the accuracy of information returns before issuing notices of deficiency. We believe this proposal would render the IRS' matching program inoperable. Without this program, the IRS would need substantial additional resources to reach the same level of compliance with the tax laws that we have today.

I believe that a proper balance is achieved under existing IRS standards, which were revised in 1993 to respond to the concern underlying this H.R. 661 and S. 258 provision. Under the revised standards found in the Internal Revenue Manual, if, in a court proceeding, a taxpayer asserts a reasonable dispute with respect to any item of income reported on an information return and the taxpayer has fully cooperated with the IRS, the government must present "reasonable and probative information" concerning this income in addition to presenting the information return. A fully cooperative taxpayer is one who provides, within a reasonable period of time, access to and inspection of all witnesses, information, and documents within its control to the extent reasonably requested by the IRS.

An H.R. 11 proposal to reform the Service's information reporting procedures provided the same standards as those currently in the Internal Revenue Manual. The H.R. 11 proposal reflected the joint effort of the Service and Treasury working with Congress to respond to the concern underlying both that proposal and the H.R. 661 and S. 258 proposal. The H.R. 11 proposal is responsive to this concern. We believe that it strikes a reasonable and appropriate balance between the rights and obligations of both taxpayers and the government.

Burden of Proof

I would like to turn now to H.R. 390. H.R. 390 contains a provision that would shift the burden of proof to the IRS during any court proceeding. The bill provides:

> Notwithstanding any other provision of this title, in the case of any court proceeding, the burden of proof with respect to all issues shall be on the Secretary.

Madame Chairman, that provision alone would undermine the Federal income tax system. Not only would it undermine the Federal tax system, but also the state tax systems that depend on Federal deficiency assessments -- assessments which would simply evaporate if this provision were enacted.

The current burden of proof rules have been in place for well over a century and are closely woven into the fabric of our system of voluntary compliance. While proposals to shift the burden of proof to the government have been advanced during this period, in each instance, these proposals have been rejected. The reasons for rejection were briefly stated by a member of the Board of Tax Appeals (predecessor to the current U.S. Tax Court) during a 1925 debate on a proposal that, like H.R. 390, would have placed the burden of proof on the government:

> [Y]ou might as well repeal the income tax law and pass the hat, because you will be practically saying to the taxpayer, How much do you want to contribute toward the support of the government? [A]nd in that case they would have to decide for themselves.

The Internal Revenue Code and the administrative policies of the IRS contain many procedures designed to foster the administrative settlement of civil tax disputes. Indeed, these procedures result in the successful resolution of the vast majority of the civil disputes that arise under the tax laws. Not all disputes can be resolved administratively, however, and the Code permits taxpayers dissatisfied with the outcome of these administrative proceedings to seek relief in court.

Throughout the history of tax litigation in this country, the taxpayer has been required to bear the burden of proof in tax disputes. This allocation of the burden of proof is in keeping with common law traditions, is sensible and fair, and reflects some of the fundamental principles that underlie our system of taxation.

How the Current Rules Work

Generally, in civil tax litigation, the burden of proof is on the taxpayer. Thus, in cases in which the government questions the reporting of income or deductions or credits of a taxpayer and has made an administrative determination that additional tax is due under the law, and the taxpayer has exhausted his or her rights in the examination and administrative appeals processes, the taxpayer may go to court and ask the court to redetermine his or her liability. The burden is on the taxpayer to persuade the court that the determination made by the Commissioner of Internal Revenue is wrong and should be adjusted. Likewise, in those cases where the taxpayer contends that he or she has paid too much tax and wants the government to refund part or all of those payments, the burden is on the taxpayer. (In those situations where liability is imposed for civil fraud (the government seeks to impose the civil fraud penalty) or where there is alleged criminal liability (the government seeks to fine or incarcerate a person for violation of a criminal statute), the burden of proof is on the government -- a situation that for good reason should continue.)

Reasons to Leave the Current Rules in Place

There are good reasons not to change current law. First, the current rules are consistent with the voluntary self-assessment system, which presumes that taxpayers, and not the government, are best able to maintain and produce records that substantiate items on tax returns.

Second, placing the litigation burden of proof on taxpayers promotes administrative resolution of tax cases. Under the current system, taxpayers cannot prevail in court without marshalling and producing evidence in their favor. Knowledge of this ultimate burden provides an incentive for them voluntarily to produce information during audit and subsequent administrative proceedings. If this were not the case -- as it surely would not be if the government had the burden of producing all records necessary to challenge taxpayer assertions that they owe little or no tax -- taxpayers could "stonewall" auditors and examiners, playing a game of "catch me if you can."

Third, taxpayers, like other claimants, should bear the burden of proving their claims in court. Under the common law, parties challenging administratively proper determinations of government agencies are typically required to shoulder the burden of proof. The Code and current administrative practices of the

Internal Revenue Service ensure that taxpayers have many opportunities to seek resolution of tax disputes short of litigation. Disputes that end up in court do so only after a thorough consideration of the issues by the government (or taxpayer neglect of the administrative process).

Finally, considerations of fairness and efficiency require that taxpayers bear the burden of proof. Common law generally places the burden of proof on the party with most ready access to the evidence necessary to adjudicate claims. This common law tradition is not only consistent with principles of fairness, it substantially lessens the need for court-supervised and intrusive discovery during both administrative and court proceedings.

It is, moreover, unrealistic to expect that the government has either the resources or the ability to prove that all taxpayer claims -- no matter how outlandish -- are false. For example, a taxpayer claiming $50,000 for business supplies, could readily show that the deductions were proper simply by producing records of what was purchased, for what amount, and for what business purpose. It would be nearly impossible, however, for the Service to show that a claimed deduction was improper.

Many Internal Revenue Code sections contain provisions with very specific requirements for favorable tax treatment. If the government were required to prove that taxpayers do not meet the requirements for favorable tax treatment, aggressive taxpayers would be encouraged to take unsupported positions. In the end, the changes produced by H.R. 390 would reward aggressive taxpayers at the expense of compliant ones.

Passage of H.R. 390 Is Not in the Best Interest of Tax Administration or Taxpayers

I believe H.R. 390, if enacted, would not serve the best interests of sound tax administration and the American taxpayer. Shifting the burden of proof would undermine the record-keeping requirements of the Code. There would be little incentive for taxpayers to maintain records of their business and income producing activities. Rather, taxpayers would be encouraged to keep or produce nothing about their tax affairs and require the government to disprove every item on their return. Indeed, the absence of records would preclude a government challenge to virtually any taxpayer claim. "Recordless" taxpayers, including those who earn income from illegal sources, would be rewarded.

Passage of H.R. 390 also would necessitate additional information gathering by and reporting to the government. Audits performed with the burden of proof on the Service would involve a much broader and more detailed inspection of the financial affairs of the taxpayer and third parties. Rather than simply choosing certain items of the taxpayer's return to review according to specific enforcement criteria, the Service would of necessity need to challenge a greater number of items. The audits would be much more costly to taxpayers and the IRS because they would take longer and involve many more requests for information. They would also be more burdensome on third parties with whom the taxpayer has done business. Taxpayers would have no incentive to correct inadequacies in their records. Rather, the government would have to fill in the gaps by obtaining information from financial institutions, employers, employees, suppliers, contractors, etc., in order to "prove" that the taxpayer owed more taxes than reported. In summary, the Service's enforcement and collection activities would be infinitely more intrusive than they are today.

Additionally, not only would the government have to make extensive investigations of taxpayers, it would also be required to maintain extensive records about taxpayers. In order to carry its burden of proving that potential taxpayer claims were without

merit, the government would have to obtain and retain substantially more information about all taxpayers than is currently the case. All of this activity would entail invasion of personal privacy of the taxpayer on a level not found in the current system.

Finally, court proceedings would be burdened by the rule change. The only response the government could make to a shifting of the burden is to increase the amount of discovery it conducts in litigation. Taxpayers would have no incentive to turn over tax information voluntarily in such proceedings. Extensive, intrusive, and expensive, discovery battles would become more common, and court dockets would swell because of the discovery logjam.

A few examples will illustrate how the passage of H.R. 390 would substantially increase the costs of administering the tax system and burden the courts. In a routine dispute over depreciation deductions, the government would have to prove the cost of assets, the dates of acquisition, and previous allowances for depreciation in order to obtain a court ruling on the question. If the government could not obtain the taxpayer's records or the records it could obtain were inadequate to prove any of these items, the taxpayer, no matter how meritless the claim, would be entitled to prevail.

Also, if H.R. 390 were enacted, in every case in which a tax protestor claimed on its return that wages are not income, the government would have to come to court with the records to prove that the taxpayer had, in fact, been paid wages. In most cases, the government would have to obtain the records from the taxpayer's employer and require that one of the employer's bookkeepers or supervisors appear in court to authenticate records detailing wage payments and the fact of the protestor's employment.

In practical effect, passage of H.R. 390 would virtually immunize from challenge many of the itemized deductions claimed on Schedule A, would require the government to examine substantially more records to fend off claims, and would compel the government to engage in costly searches for corroboration of facts that unfortunately not all taxpayers would willingly acknowledge. In the end, passage of H.R. 390 would substantially increase the costs of administering the revenue system, substantially reduce the revenues the government should properly collect under the laws the Congress has enacted, and disadvantage honest taxpayers who keep proper records. Madame Chairman, I believe, as I think you will hear from a number of sources who are interested in sound tax administration, that passage of H.R. 390 would destroy our voluntary compliance system.

TAX SYSTEMS MODERNIZATION

You have asked for my views as to how best to enhance taxpayer rights. In today's dynamic, service-oriented, business environment, taxpayers have come to expect prompt access to information and assistance with account inquiries and problems -- the type of access and assistance they receive in the private sector. Unfortunately, however, the IRS simply cannot deliver this level of service with our 30 year old technology. Only through modernization of our technologies will we be able to successfully meet the demands of taxpayers and provide taxpayer rights. Therefore, I am asking that you assist us in obtaining the tools we need to properly serve our customers by ensuring full and stable funding of our Tax Systems Modernization (TSM) program.

I would like to close with a simple yet poignant illustration of the types of things that TSM will enable us to do for the cause of taxpayer rights. Earlier in my testimony, I

discussed several problems associated with section 301 of H.R. 661 and S. 258 -- a proposal to expand the IRS' authority to abate interest assessments and to require the IRS to abate interest assessments in certain cases. But what if we eliminate the need for these interest assessments in the first place without exposing the tax system to the problems presented by the interest abatement proposal?

TSM holds the key to providing drastic reductions in the amounts of interest assessed to taxpayers. When TSM is fully implemented with its on-line capabilities, our goal is to match information documents at the time a return is filed, not almost two years later as they are today. This means that almost 2 years worth of interest assessments could be eliminated for every taxpayer with an unpaid tax balance that is detected through our information document matching programs.

TSM will also reduce errors, reduce the time it takes to begin and conduct examinations, speed up account problem resolution for taxpayers, and accelerate collection activities, thus providing further opportunities for reductions in the amount of interest assessments.

With TSM fully implemented, systemic improvements would be possible that would improve the efficiency of the government, benefit all taxpayers, and result in significant interest assessment reductions. The IRS and taxpayers are already reaping many of the benefits of TSM today. It is a reality -- and we need your assistance to bring it to full and successful completion.

CONCLUSION

Madame Chairman, I am committed to an IRS that expects no less than that all its employees be taxpayer advocates while at the same time ensuring that taxpayers who are compliant with the tax laws are not disillusioned by those who use procedural loopholes to game the system. I would like to thank you and your colleagues for the opportunity to provide our views and comments in this important area and look forward to working with you to develop proposals that truly protect the rights of taxpayers and reduce their compliance burdens.

I would be happy to remain until after Lee Monks has finished his prepared statement to answer any questions you or the other Subcommittee members may have.

APPENDIX DISCUSSION OF H.R. 661 and S. 258 THE "TAXPAYER BILL OF RIGHTS 2"

This appendix provides a general discussion about the provisions of H.R. 661 and S. 258 (both cited as "Taxpayer Bill of Rights 2") and their effects on tax administration. This discussion is offered by the Internal Revenue Service to assist the Subcommittee as it explores the development of legislation that would provide additional safeguards for taxpayers' rights.

The discussion provided in this appendix is based on an important assumption that where the provisions of H.R. 661 and S. 258 overlap with provisions contained in H.R. 11 of the 102d Congress, the legislative history reflected in H. Rep. No. 1034, 102d Cong., 2d Sess. (1992) would be adopted as the legislative history to both H.R. 661 and S. 258.

The Subcommittee should note that the discussion of provisions contained in this appendix represents only the views of the Commissioner of Internal Revenue. Also, the staff of the Internal Revenue Service is continuing its analysis of the provisions and may have further technical comments to share with the Subcommittee staff in the future.

Nothing in the discussion of the provisions should be interpreted as constituting an official position of the Administration. The Administration would be pleased, however, to assist the Subcommittee with official positions, revenue estimates, and, where necessary, appropriate offsets to ensure deficit neutral implementation of any provisions of the bills that the Subcommittee decides to advance.

The following provisions would help to make the tax system fairer and more administrable:

§ 302. Extension of interest-free period for payment of tax after notice and demand. The current law's 10-day interest-free period upon notice and demand would be extended to 21 days for tax liabilities (including interest and penalties) of less than $100,000. The shorter 10-day period would continue to apply to amounts of $100,000 or more. Conforming changes would also be made to the failure-to-pay penalty.

§ 401. Disclosure of joint return collection activities. If the IRS has assessed a deficiency for a joint return, the IRS would have the discretionary authority, upon the written request of one of the spouses (or former spouses), to disclose whether the IRS had attempted to collect the assessed deficiency from the other spouse (or former spouse), the general nature of any such collection activities, and the amount of the deficiency collected from the other spouse (or former spouse). Although it is believed that such disclosure already is authorized under current law, this proposal would make explicit the IRS' disclosure authority in cases relating to separated or divorced spouses.

§ 402. Joint return may be made after separate returns without full payment of tax. Under current law, married taxpayers who file separate returns for a taxable year in which they are entitled to file a joint return may elect to file a joint return after the time for filing the original return has expired. The election to refile on a joint basis may be made only if the entire amount of tax shown as due on the joint return is paid in full by the time the joint return is filed. The bills would repeal this requirement.

§ 601. Phone number of person providing payee statements required to be shown on such statement. The bills would require that information returns include the telephone number of the payer's information contact, in addition to the currently required payer name and address.

§ 902. Treatment of substitute returns under section 6651. Under current law, if no return is filed by the taxpayer, the IRS may file a substitute return for the taxpayer. If the IRS files a substitute return for the taxpayer, the failure-to-pay penalty runs from ten days after the IRS sends the taxpayer a notice and demand for payment of the tax.

The bills would provide that the failure-to-pay penalty for substitute returns would apply in the same manner as for other returns. Thus, the penalty in each case would run from the due date of the return until the tax is paid.

If modified, the following provisions also would generally improve tax administration:

§ 203. Notification of reasons for termination or denial of installment agreement. Currently, the IRS is required to give a taxpayer 30-days notice before terminating an installment agreement due to a change in the taxpayer's financial condition. The bills would extend the 30-day installment agreement notification and explanation requirement to all cases in which the IRS may deny, alter, modify, or terminate an installment agreement (other than cases in which the IRS believes the collection of the tax to which the installment agreement relates is in jeopardy).

Through recently issued final regulations, the IRS already has adopted and implemented procedures requiring it to notify taxpayers 30 days prior to altering, modifying or terminating installment agreements, unless doing so would jeopardize collection.

Modifications necessary to facilitate tax administration: A notification requirement should not be imposed for denials of installment agreements, because this would permit taxpayers to stay collection during the notice period by merely requesting an installment agreement. During the 30-day period after notification of denial, a taxpayer that wished to evade collection enforcement actions could transfer assets to related persons, sell non-liquid assets and conceal its possession of the liquid asset proceeds, shift assets outside of the country, etc.

§ 204. Administrative Review of Denial of Request for, or Termination of, Installment Agreement. Under current law, the IRS is authorized to enter into written installment agreements with taxpayers to facilitate the collection of tax liabilities. In general, the IRS has the right to terminate (or in some instances, alter or modify) such agreements if the taxpayer provided inaccurate or incomplete information before the agreement was entered into, the taxpayer fails to make a timely payment of an installment or another tax liability, the taxpayer fails to provide the IRS with a requested update of financial condition, the IRS determines that the financial condition of the taxpayer has changed significantly, or the IRS believes collection of the

tax liability is in jeopardy. Except in cases where the collection of the tax liability is in jeopardy, regulations require the IRS to provide the taxpayer with a written notice that explains the IRS determination at least 30 days before altering, modifying or terminating the installment agreement.

The bills would permit a taxpayer whose request for an installment agreement is denied, or whose installment agreement is terminated, to seek an independent review of the decision.

Modifications necessary to facilitate tax administration: Denials of installment agreements should not be subject to appeal because this would permit taxpayers to stay collection during the notice period. See additional analysis and examples of concerns in section 203. The IRS has recently completed an eighteen-month pilot program for independent review of all collection activities (including enforcement actions) and is in the process of evaluating the pilot. The IRS would be happy to work with the Subcommittee to review the results of the pilot program. The Subcommittee may find such an approach helpful in evaluating the need for a statutory change in this area.

§ 501. Modifications to lien and levy provisions. To protect the priority of a tax lien, the IRS must file a notice of lien in the public record. Under current law, the IRS has discretion in filing such a notice, but once a notice is filed, the IRS may release it only if the notice was erroneously filed or if the underlying liability has been paid, bonded or become unenforceable. If a notice has been improvidently filed, it can not be released because release would extinguish the underlying lien. The IRS is authorized to return levied-upon property to a taxpayer only when the taxpayer has overpaid its liability for tax, interest, and penalty. In any event, certain property of a taxpayer is exempt from levy. The exempted property includes personal property with a value of up to $1,650 and books and tools necessary for the taxpayer's trade, business or profession with a value of up to $1,100.

Under the bills, the IRS would have the authority to withdraw a notice of federal tax lien if (1) the filing of the notice was premature or was not in accordance with the administrative procedures of the IRS; (2) the taxpayer has entered into an installment agreement for the payment of tax liability with respect to the tax on which the lien is imposed; (3) the withdrawal of the notice would facilitate the collection of the tax liability; or (4) the withdrawal of the notice would be in the best interest of the government and the taxpayer. If the taxpayer so requests in writing, the IRS would be required to notify credit reporting bureaus and financial institutions that the notice has been withdrawn. In addition, the IRS would be allowed to return levied-upon property to the taxpayer in the same four circumstances. Finally, the exemption amounts under the levy rules would be increased to $1,750 for personal property and $1,250 for books and tools. Both these amounts would be indexed for inflation.

Modifications necessary to facilitate tax administration: The IRS is concerned with only one of the four situations under which the IRS would be authorized to withdraw a notice of federal tax lien (i.e., the situation in which a taxpayer has entered into an installment agreement for the payment of tax liability with respect to the tax on which the lien is

imposed). Situations (1), (3), and (4) would give the Service the latitude to withdraw a notice of federal tax lien where taxpayers have entered into installment agreements, without the necessity of citing situation (2) as a candidate for potential relief. Citing situation (2) as a candidate for potential relief might permit less scrupulous taxpayers to enter into an installment agreement, convince the IRS to withdraw the notice of federal tax lien, and then default on the installment agreement after having disposed of assets that could be used to satisfy the liability.

§ 502. Offers-in-compromise. Under current law, the IRS may compromise any assessed tax if there is sufficient doubt about whether the tax is owed or is collectible. However, if the compromised amount is $500 or more, a written opinion of the Chief Counsel is required. Under the bills, the IRS would be authorized to compromise an assessed tax if doing so would be in the best interest of the government. A written supporting opinion of the Chief Counsel would be required only if the unpaid amount were $50,000 or more. The IRS would be required to subject these offers-in-compromise to continuing IRS quality review.

Modifications necessary to facilitate tax administration: Congressional concerns could be even better addressed by increasing the threshold for Chief Counsel review from $50,000 to $100,000. The IRS is concerned, however, that the proposed "best interest of the government" standard would be difficult to administer. The IRS now believes that its current interpretations of the existing standards for offer-in-compromise eligibility provide adequate flexibility to ensure that the program is fairly administered.

§ 702. Disclosure of certain information where more than 1 person subject to penalty. Under current law, the IRS may not disclose to a responsible person the IRS' efforts to collect unpaid trust fund taxes from other responsible persons who may be liable for the same tax. Under the bills, the IRS would be required to disclose to a person considered by the IRS to be a responsible person, if requested in writing by that person, the name of any other person the IRS has determined to be a responsible person with respect to the tax liability. The IRS also would be required to disclose whether it has attempted to collect this penalty from other responsible persons, the general nature of those collection activities, and the amount (if any) collected. Failure by the IRS to follow this provision does not absolve any individual of any liability for penalty.

Privacy-related modifications: To better protect taxpayers, the proposal should be modified to preclude recipients of the disclosed information from improperly re-disclosing it. Additionally, the statute or legislative history should clearly provide that if the IRS' determination as to whether a person is considered a responsible person is judicially overturned, the Service would not be considered to have violated the requirements of section 6103 of the Internal Revenue Code.

§ 703. Penalties Under Section 6672. Under current law, a "responsible person" is subject to a penalty equal to 100 percent of trust fund taxes that are not collected and paid to the IRS in a timely manner. The rules for determining

whether a person is a "responsible person" are the same for taxable and tax-exempt organizations. The IRS is not required to promptly notify taxpayers who fall behind in depositing trust fund taxes.

There are three components to the bills. First, the IRS would be required to take appropriate action to ensure that employees are aware of their responsibilities under the Federal tax depository system, the circumstances under which employees may be liable for the penalty, and the responsibility to promptly report failures in payments to the IRS. These actions would include printing warnings on payroll tax deposit coupon books and appropriate tax returns indicating that employees may be liable for this penalty, and developing a special information packet relating to this penalty.

Second, the section 6672 penalty would not apply to volunteer, unpaid members of any board of trustees or directors of a tax-exempt organization to the extent such members are solely serving in an honorary capacity and are not participating in the day-to-day or financial activities of the organization. This exception for unpaid volunteers would not apply if the volunteers had actual knowledge of the failure to pay or collect or if this proposal resulted in no person being held liable for the penalty.

Third, the IRS would be required, to the maximum extent practicable, to notify all persons who have failed to make timely deposits of trust fund taxes within 30 days after the return was filed reflecting such failure or after the date on which the IRS is first aware of such failure. If the person failing to make the deposit is not an individual, the IRS must notify the entity. The entity, in turn, would have 15 days from receipt of the IRS notice to notify all of its officers, general partners, trustees, or other managers. Failure of the IRS to provide notice under this proposal would not absolve any individual of any liability for a penalty.

> Modifications necessary to facilitate tax administration: These bills' provisions generally would complement IRS efforts to inform taxpayers about their responsibilities for trust fund taxes. However, the first part of the proposal raises some problems. As the IRS shifts both to alternative (non-paper) forms of making tax deposits and filing payroll tax returns, the use of the coupon booklets and forms to inform taxpayers about their responsibilities for trust fund taxes makes less sense. Fewer taxpayers will be using the coupon booklets and the forms in the future as these alternative payment and filing options grow. (The North America Free Trade Agreement, for example, requires use of electronic funds transfer for depository taxes. With this movement toward electronic payments, the use of paper coupons containing any written notification will substantially diminish or be eliminated.)
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> Additionally, the Service is concerned that with its current information systems, it could not meet the 30-day notification requirement. A 60-day notification requirement is more realistic. Future improvements in IRS information systems under Tax Systems Modernization would facilitate meeting a 30-day requirement.

§ 803. Failure to agree to extension not taken into account. Under current law, to qualify for an award of attorney's fees, the taxpayer must have exhausted the administrative remedies available within the IRS. The bills

provide that any failure to agree to an extension of the statute of limitations could not be taken into account in determining whether a taxpayer had exhausted administrative remedies for purposes of determining eligibility for an award of attorney's fees.

Modifications necessary to facilitate tax administration: This provision generally reflects current law. However, the provision should not apply to taxpayers who fail to fully respond to IRS requests for information on a timely basis.

§ 904. Required notice of certain payments. Under current law, if the IRS receives a payment without sufficient information to credit it to a taxpayer's account, the IRS may attempt to contact the taxpayer. If contact cannot be made, the IRS places the payment in an unidentified remittance file.

The IRS would be required by the bills to make reasonable efforts to notify, within 60 days of receipt, taxpayers that have made payments which the IRS cannot associate with any outstanding tax liability. Such a requirement is consistent with current IRS practices.

Modifications necessary to facilitate tax administration: While this requirement is reasonable and consistent with current IRS practices, a minor technical modification is necessary to accommodate situations in which a taxpayer will deposit an amount toward a liability that technically is yet to arise (e.g., an estimated tax payment toward a current year's liability that technically is not yet an "outstanding tax liability"). When a taxpayer makes such a deposit, with or without specific instructions, the IRS generally credits the deposit to the current year's liability. In such situations, a requirement to notify the taxpayer of application of the deposit to its current liability would be unnecessary and potentially burdensome to the taxpayer. Either the statute or the legislative history should make it clear that routine deposits toward future liabilities are not intended to be affected by the provision. Perhaps this could be accomplished by substituting "identifiable tax liability" for "outstanding tax liability" in the statutory language and legislative history.

§ 1001. Explanation of Certain Provisions. Under current law, the IRS may enter into installment agreements, accept offers in compromise, and extend the time for paying tax. The bills would require the IRS to take appropriate actions to ensure that taxpayers are aware of the availability of installment agreements, offers in compromise, and extensions of time to pay tax. The IRS would have to do so in both instructions for income tax returns and collection notices.

Modifications necessary to facilitate tax administration: The IRS already informs taxpayers of their right to enter into an installment agreement in both instructions to income tax returns and collection notices. Although the IRS has no objection to including information on offers in compromise and extensions of time to pay tax in collection notices, inclusion of this information on the instructions to tax returns could cause some taxpayers not to pay their determined liabilities, even where they have the ability to pay. In evaluating the desirability of this provision, adequate consideration must be given to the rights of the majority of taxpayers who make timely and full payment of their determined liabilities.

§ 1011. Pilot Program for Appeal of Enforcement Actions. Under current law, a taxpayer who disagrees with an IRS collection action generally may appeal to successively higher levels of management with Collection.

The bills would require the IRS to establish a one-year pilot program allowing taxpayers to appeal enforcement actions (including lien, levy, and seizure) to the Appeals Division. This would be permitted where the deficiency was assessed without the actual knowledge of the taxpayer, where the deficiency was assessed without an opportunity for administrative appeal, and in other appropriate cases. The IRS would have to report to the tax-writing committees on the effectiveness of the pilot program.

Modifications necessary to prevent duplication of efforts: The IRS has recently completed an eighteen-month pilot program for independent review of all collection activities (including enforcement actions) and is in the process of evaluating the pilot. It seems likely that this proposal was carried over from H.R. 11 (which was debated prior to completion of this pilot program), without recognition of the fact that the IRS had already completed its pilot program. The Subcommittee may find it helpful to discuss the results of the pilot program with the IRS before proceeding with a statutory change.

Other provisions that would either codify current IRS practices or assist taxpayers in ways that would not undermine the administrative process are highlighted below. For certain provisions, minor modifications are provided to ensure that the administrative process is not compromised.

§ 505. Safeguards relating to designated summons. In general, current law provides that if the IRS issues a "designated summons" to a corporation at least 60 days prior to the expiration of the statute of limitations for the assessment of tax, the statute of limitations is suspended either until a court determines that compliance is not required or until 120 days after the corporation complies with the summons pursuant to a court's determination.

Consistent with current IRS practices, the bills would provide that no designated summons could be issued with respect to a corporation's tax return unless the summons first was reviewed by the IRS Regional Counsel for the Region in which the examination of the corporation's return was being conducted. The IRS also would have to promptly notify in writing any corporation the return of which is in issue of any designated summons (or another summons, the litigation over which suspends the running of the assessment period under the designated summons procedure) issued to a third party.

§ 602. Civil Damages for Fraudulent Filing of Information Returns. Current federal law provides no cause of action to a taxpayer who is injured because a false or fraudulent information return has been filed with the IRS by another person asserting that the other person made payments to the taxpayer. It does, however, provide for criminal sanctions that apply to the intentional filing of false information returns.

The bills would provide that if a person willfully files a false or fraudulent information return, the affected person may bring a suit to recover damages from the person who filed the return. A $5,000 damage floor is provided.

Modifications: If this provision is advanced, the legislative history should provide that the outcome of the parties' civil litigation on the issue as to whether a person willfully filed a false or fraudulent information return should have no effect on an independent action taken by the government with respect to the payor for the intentional filing of a false information return.

§ 701. Preliminary notice requirement. Under current law, a "responsible person" is subject to a penalty equal to 100 percent of trust fund taxes that are not collected and paid to the government on a timely basis. If the IRS determines that an individual is a responsible person, he or she may appeal that determination administratively.

As is current practice, the bills would require the IRS to issue a notice to any individual the IRS had determined to be a responsible person with respect to unpaid trust fund taxes at least 60 days prior to issuing a notice and demand for the penalty. The statute of limitations for the assessment of the penalty would not expire before the date that is 90 days after the notice was mailed. The proposal would not apply if the Secretary determined that the collection of the penalty was in jeopardy.

§ 801. Motion for Disclosure of Information. Under current law, a taxpayer that successfully challenges a deficiency may recover attorney's fees and other administrative and litigation costs if the taxpayer qualifies as a "prevailing party". A taxpayer qualifies as a prevailing party if it (i) establishes that the position of the United States was not substantially justified; (ii) substantially prevails with respect to the amount in controversy or the most significant issue or set of issues presented; and (iii) meets certain net worth and (if the taxpayer is a business) size requirements.

The bills would provide that once a taxpayer had substantially prevailed in court, it could file a motion for the court to order the IRS to disclose all information and records in its possession with respect to the taxpayer's case.

§ 802. Increased limit on attorney fees. The maximum base rate for attorneys' fees would be increased from $75 to $110 per hour and would be indexed for inflation.

§ 905. Unauthorized Enticement of Information Disclosure. The Internal Revenue Code currently contains no provision prohibiting a tax professional from disclosing information about his or her clients to the IRS in exchange for forgiveness of the professional's tax liability.

The bills would create a civil cause of action if a government employee intentionally offers to compromise the tax liability of a professional tax advisor in exchange for information from that advisor about its client. The cause of action would permit the taxpayer to sue the government in district court without regard to the amount in controversy. Damages would equal the lesser of $500,000 or the sum of (i) actual economic damages sustained by the taxpayer as a proximate result of the information disclosure, and (ii) the costs of the action. The provision would not apply to information conveyed to a professional for the purpose of perpetrating a fraud or crime. The provision is not intended to apply to examination and collection activities of the IRS done in the ordinary course of its determination or collection of tax.

§ 1002. Improved Procedures for Notifying Service of Change of Address or Name. Generally, under current law, the IRS posts the new address of a taxpayer only when the taxpayer files a subsequent return or Change of Address form. If the taxpayer notifies the IRS of a new address on a return, this information is recorded on the IRS master file immediately. If the IRS is notified in other ways, the change of address information is recorded by the IRS only after it processes refunds and returns that show a balance due.

The bills would require the IRS to provide improved procedures for address changes and to institute procedures for timely updating all IRS records with change-of-address information provided by taxpayers. The proposal is generally consistent with the spirit of current IRS initiatives to improve IRS procedures regarding name and address change notification.

§ 1003. Rights and Responsibilities of Divorced Individuals. Although the IRS provides information on the rights and responsibilities of divorced individuals, this subject is not discussed in Publication 1, "Your Rights As a Taxpayer." The bills would require the IRS to include a section on the rights and responsibilities of divorced individuals in Publication 1.

> Modifications: This type of information is not generally consistent with the other information discussed in Publication 1 and there may be better ways of communicating these rights and responsibilities to divorced individuals. It may be more helpful to taxpayers, for example, to include a cross-reference in Publication 1 to our Publication 504, "Divorced or Separated Individuals."

§ 1012. Study on Taxpayers With Special Needs. The bills would require the IRS to conduct a study of ways to assist needy persons in complying with the tax laws. These persons would consist of the elderly, physically impaired, foreign-language speaking, and other taxpayers with special needs.

This proposal is generally consistent with the substantial efforts exerted by the Service in reaching out to needy groups to assist them in understanding and carrying out their obligations under the Federal tax laws. Examples of these initiatives include (i) the Volunteer Income Tax Assistance (VITA) program for low income, disabled and non-English speaking individuals; (ii) the Tax Counseling for the Elderly (TCE) program; (iii) videotaped instructions for completing returns in English and Spanish; (iv) materials in Braille and large print forms and instructions for the seeing-impaired; and (v) telephone assistance for the hearing-impaired.

§ 1013. Reports on Taxpayer Rights Education Programs. The bills would require the IRS to report to the tax-writing committees on the scope and content of its taxpayer rights education program.

§ 1014. Biennial Reports on Misconduct of IRS Employees. The bills would require the IRS to report to the tax-writing committees on employee misconduct cases.

To some extent, this reporting requirement duplicates other efforts. The IRS is already required by the Inspector General Act to report information on Inspection's investigative activities, including employee misconduct, to the Treasury Department Inspector General every six months. The Inspector General prepares a semiannual report to the Congress. The report includes summary information,

statistics, and descriptions of significant investigative activities within the Department. The report is sent to the Senate Governmental Affairs and Finance Committees and the House Government Reform & Oversight and Ways & Means Committees. These reports are available to the public.

Modification: The provision should be clarified to provide that it is not intended to require information, by employee name, on complaints, allegations, and investigations. Without such clarification, the provision would have the potential to invade the privacy of employees. Irreparable harm could be done to an employee's reputation if allegations against the employee were later proved unfounded or frivolous.

§ 1015. Study of Notices of Deficiency. The bills would require the GAO to study the effectiveness of IRS efforts to notify taxpayers about tax deficiencies.

§ 1016. Notice and Form Accuracy Study. The bills would require the GAO to conduct annual studies of the accuracy of the 25 most commonly used IRS forms, notices and publications.

In their current form, the following provisions would pose serious administrative problems.

§ 101. Establishment of position of taxpayer advocate within IRS. Under current law, the Taxpayer Ombudsman is appointed by and reports to the Commissioner. The Ombudsman's responsibilities are to bring the viewpoint of the taxpayer to IRS' policy and planning formulation. In addition, the Ombudsman oversees the operation of two programs to assist taxpayers. The first is the Taxpayer Assistance Order Program, under which the Ombudsman is authorized to issue a Taxpayer Assistance Order ("TAO") to assist taxpayers who otherwise would suffer significant hardship as a result of the manner in which the IRS is administering the tax laws. A TAO can require the IRS to release property of the taxpayer levied upon by the IRS or to cease action or refrain from taking action against the taxpayer. The second Ombudsman program is the Problem Resolution Program (PRP), which deals with cases in which IRS systems do not properly or timely handle the taxpayer's case or inquiry. Under this program, taxpayers receive special attention until their issue has been resolved.

Under the bill, the Ombudsman's title would be changed to the Taxpayer Advocate. As under current law, the Taxpayer Advocate would head an office in the IRS that reported directly to the Commissioner and would have responsibility for all aspects of the PRP Program, including Taxpayer Assistance Orders. Instead of reporting to the head of office, which is the current IRS practice, IRS employees in the field participating in the problem resolution program would report directly to the Taxpayer Advocate. In addition to the currently mandated annual report on taxpayer services prepared by the Ombudsman and Taxpayer Services, the Taxpayer Advocate would issue two reports each year to the tax-writing committees on past activities and future objectives of the office. The reports would include legislative recommendations. The IRS would be required to establish procedures requiring a formal response to all recommendations submitted to the Commissioner by the Taxpayer Advocate.

The Office of the Ombudsman has successfully carried out the directives of the Taxpayer Bill of Rights 1. Requiring field personnel to report directly to the Taxpayer Advocate would undermine grassroots accountability of the Ombudsman.

A procedural modification under which TAO decisions of the problem resolution officers could be appealed only to the Ombudsman (rather than to the District Directors as under current IRS procedures) could address Congressional concerns over the independence of the Ombudsman.

§ 102. Expansion of authority to issue taxpayer assistance orders. Taxpayer Assistance Orders under current law include the power to release taxpayer property levied upon by the IRS and to require the IRS "to cease any action, or refrain from taking any action" against a taxpayer that will otherwise suffer "significant hardship" as a result of the manner in which the IRS is administering the tax laws. A TAO may be modified or rescinded by the Ombudsman, a district director, a service center director, a compliance center director, a regional director of appeals or any of their superiors.

Under the bills, the authority to issue TAOs would be expanded to permit the IRS to affirmatively "take any action" with respect to taxpayers who otherwise would suffer a significant hardship as a result of the manner in which the IRS is administering the tax laws. The persons who could modify or rescind a TAO would be narrowed to consist only of the Taxpayer Advocate, the Commissioner, or a superior of the Taxpayer Advocate or the Commissioner. The provision would clarify that the Taxpayer Advocate could not determine the substantive tax treatment of any item.

The bills would also authorize TAOs for taxpayer "hardship," rather than "significant hardship." Eliminating the "significant hardship" requirement is troubling in that it would make the special relief provided by TAOs effectively available to all taxpayers other than the very small group of taxpayers for whom the timely payment of tax does not pose any hardship. This TAO expansion could present significant revenue consequences. Also, given resource constraints, the significant increase in the number of applications for TAOs that could be expected to result from expansion of the TAO standard could seriously undermine the Service's ability to serve those taxpayers whose needs are most pressing.

Other portions of this provision that expand the Ombudsman's TAO authority are also unnecessary. By delegation order, the Commissioner already has expanded the Ombudsman's TAO authority. This expanded authority includes the authority to take those affirmative actions, in addition to the current authority to cause the IRS to cease any actions, that appear to be the focus of Congress' concern (e.g., to issue TAOs to abate assessments, expedite refunds, and stay collection activity).

Finally, the bills' provision narrowing the number of individuals who could modify or rescind a TAO to only the Taxpayer Advocate or his delegate, the Commissioner, or a superior of the Taxpayer Advocate or the Commissioner is generally consistent with one of the Service's preferred alternatives to section 101 of the bills (i.e., ensuring that problem resolution officer's decisions on TAOs are appealable only to the Taxpayer Advocate). The Service's suggested statutory language here, however, would (1) clarify that, for purposes of section 7811 (concerning TAOs), "Taxpayer Advocate" includes those individuals that are part of the Office of Taxpayer Advocate and all problem resolution officers, and (2) limit those individuals that could modify or rescind a TAO to only the Taxpayer Advocate (as defined above) or the Commissioner.

§ 201. Taxpayer's right to installment agreement. Under current IRS procedures, an individual who owes less than $10,000 of income tax and can pay within a short time period generally will be granted an installment agreement for the payment of that tax upon request without providing financial information to the IRS. The request will not be granted, however, if the taxpayer has delinquencies other than those that are the subject of the request. For other situations, case resolution depends on the taxpayer's financial condition. In all taxpayer interviews, the IRS first looks for sources of full payment.

Under the bills, non-corporate taxpayers would have an automatic right to an installment payment of income tax liabilities if (1) they request an installment agreement, (2) their tax liability is less than $10,000, and (3) they timely paid tax liabilities for the 3 preceding taxable years.

Permitting taxpayers to enter into installment agreements as a matter of right would undermine a major tenet of our system -- that taxes should be paid on time. It would provide a windfall to taxpayers with liquid assets in excess of those needed to pay taxes and result in substantial revenue losses. The IRS' accounts receivable inventory would balloon and substantial resources would have to be reassigned to intrusive, after-the-fact enforcement efforts.

§ 202. Running of Failure-to-Pay Penalty Suspended. Under current law, taxpayers pay both interest and a failure-to-pay penalty on amounts paid after the due date for payment of taxes. Therefore, amounts paid under an installment agreement are subject to both interest and the failure-to-pay penalty.

For any taxpayer that enters into an installment agreement that is requested on or before the return due date, the bills would provide that the failure-to-pay penalty is suspended during the period the agreement is in effect.

This proposal would have a severe negative effect on both revenues and collections. Taxpayers who otherwise could pay taxes on time would be encouraged to pay in installments, because the interest owed the government would be less than either the return taxpayers could earn by investing the delayed payments or the general market lending rates for unsecured borrowings.

§ 301. Expansion of authority to abate interest. Under current law, the IRS has the authority to abate interest assessed with respect to a deficiency or payment that is attributable to the error by or delay of an IRS employee performing a "ministerial" act.

The bills would replace the "error or delay in performing a ministerial act" criteria for the abatement of interest by the IRS with a "unreasonable error or delay" criteria. Therefore, the bills would authorize the IRS to refund or abate interest attributable to "unreasonable" IRS errors or delays, in cases in which a taxpayer's net worth or size exceeded applicable thresholds (generally a $2 million threshold for individuals and a $7 million or 500 employee threshold for businesses or organizations). For taxpayers for which net worth or size do not exceed applicable thresholds, the IRS would be required to refund or abate interest attributable to unreasonable IRS errors or delays, but only until the date demand for payment is made.

The broadening of the standard would encourage taxpayers, particularly large taxpayers with large amounts of interest at stake, to seek relief from interest assessments as a matter of course, thereby imposing significant administrative costs, as well as controversy-related costs, on the IRS. These costs ultimately would be borne by all taxpayers. Moreover, even during delays in the resolution of an issue, taxpayers do have the use of government money on which they could earn interest. Since interest (unlike a penalty) is compensation for the use of money, the provision would represent an economic windfall to taxpayers in many cases. Additionally, "means testing" the authority to abate by imposing a net worth requirement is incompatible with the purpose of the interest charge. It also is unnecessary, as the taxpayer will receive all interest paid if the taxpayer is found to owe no tax.

The vague "unreasonable error or delay" standard for abating interest also would present significant challenges in ensuring consistent application of the law. This could undermine taxpayer confidence in the fairness of the tax system. Furthermore, because net worth is not an item that is currently reported to the IRS, the net worth requirement could not be administered without great difficulty for the IRS and taxpayers.

The expansion of authority to abate interest also is unnecessary, because the cycles for tax audits (i.e., the time from initial taxpayer contact to resolution of the audits) are very reasonable. For example, the cycle times for office (i.e., generally correspondence) and revenue agent (i.e., generally person-to-person) audits of Form 1040 are 225 days and 364 days, respectively. The cycle time for revenue agent audits of Form 1120 (other than for large corporate taxpayers in the Coordinated Examination Program) is 371 days. Within these cycle times, 120 days is "built-in," because it is represented by the time necessary for 30-day and 90-day letters. The Service cannot significantly shorten the time it takes to select a taxpayer for an audit, because of systems limitations in its current matching programs.

§ 503. Notification of examination. In general, the IRS notifies taxpayers in writing prior to commencing an examination and encloses a copy of Publication 1, "Your Rights as a Taxpayer," with the notice.

The bills would provide that, prior to commencing any examination, the IRS would be required to notify the taxpayer in writing of the examination and examination procedures. These requirements would not have to be followed if (i) the examination was in connection with a criminal investigation, (ii) the collection of the tax was in jeopardy, (iii) the requirements were inconsistent with national security needs, or (iv) the requirements would interfere with the effective conduct of a confidential law enforcement or foreign counterintelligence activity.

In many respects this provision is consistent with IRS' current procedures; for example, we generally provide written notice and a copy of Publication 1, "Your Rights as a Taxpayer," prior to commencing an examination. The provision requiring advance notice, however, would undermine some compliance efforts, including roadside inspections of highway vehicles to ensure they are not evading federal motor fuels excise taxes, compliance checks for currency transaction reporting, and unannounced visits to Electronic Return Originators to determine whether they are complying with IRS procedures.

§ 504. Increase in limit on recovery of civil damages for unauthorized collection actions. Current law provides that if an officer or employee of the IRS recklessly or intentionally disregards a provision of the Internal Revenue Code or Treasury regulations, the affected taxpayer may sue the United States for the lesser of (i) $100,000 or (ii) direct economic damages plus costs.

The bills would increase from $100,000 to $1,000,000 the damage cap for reckless or intentional disregard of the law by IRS employees. Increasing this cap would encourage lawsuits, consume IRS resources, and disproportionately benefit large taxpayers.

§ 603. Requirement to conduct reasonable investigations of information returns. Under current law, deficiencies determined by the IRS generally are afforded a presumption of correctness.

The bills would provide that if a taxpayer asserts a reasonable dispute with respect to any item of income reported on an information return filed with the IRS by a third party, the IRS, when making a determination of a deficiency based on such information return, shall have the burden of proof with respect to such determination unless the IRS has conducted a reasonable investigation to corroborate the accuracy of the information return.

Shifting the burden of proof on income reported on information returns to the IRS would render the IRS' matching program inoperable. Taxpayers, without presenting any supporting evidence, could force the IRS to investigate the accuracy of information returns before issuing notices of deficiency. Without the IRS document matching program, the IRS would need substantial additional resources to reach the same level of compliance with the tax laws that is achieved today.

A proper balance is achieved under existing standards. The IRS presumption of correctness does not outweigh credible evidence presented by the taxpayer. To prevail, the IRS must counter the taxpayer's evidence with credible evidence establishing the accuracy of the return. Any law change that prevents the IRS from asserting deficiencies on the basis of information returns could have devastating effects on the tax compliance system and profoundly increase the resource needs of the Service. The biggest component of the tax gap is unreported income. The only practicable way to reduce that component is through computerized matching of information returns. Legislation of this nature would undermine that process and result in substantial revenue loss.

IRS Internal Revenue Manual procedures have already been updated to track a H.R. 11 provision that strikes an acceptable balance between taxpayer and Government burdens. Under the H.R. 11 provision, if a taxpayer, in a court proceeding, asserts a reasonable dispute with respect to any item of income reported on an information return filed by a third party and the taxpayer has fully cooperated with the IRS, the Government, in presenting evidence of the deficiency based on the information return, must present "reasonable and probative information" concerning the deficiency in addition to the information return. In order to fully cooperate, the taxpayer must provide, within a reasonable period of time, access to and inspection of, all witnesses, information, and documents within its control to the extent reasonably requested by the IRS.

§ 804. Authority for Court to Award Reasonable Administrative Costs. Under current law, a "prevailing party" in an administrative or judicial proceeding is entitled to reasonable costs.

Though the intent of the bills' provision is not clear, it appears to provide that administrative costs could be awarded from the first action by the IRS (instead of from the Appeals office decision or notice of deficiency as under current law). Cost recoveries, however, should only be allowed after the U.S. has adopted a litigating position. The position of the U.S. during the early administrative stages cannot be judged against the "substantial justification" standard used to determine if one is a prevailing party because examining agents pursue fact-finding investigations that do not consider the hazards of litigation.

§ 901. Required Content of Certain Notices. Under current law, tax deficiency and similar notices are required to "describe the basis for, and identify" the amounts of tax, interest, additions to tax, and penalties. An inadequate description does not invalidate the notice. The bills would require that tax deficiency and similar notices instead "set forth the adjustments which are the basis for, and identify" the amounts of tax, interest, additions to tax and penalties.

The IRS already provides details of adjustments which are the basis for proposed tax assessments in notices of proposed adjustments and statutory notices of deficiency issued by the examination function. Further, the IRS is engaged in a significant ongoing effort to clarify its notices to taxpayers in a manner that is compatible with its computer capabilities. Without modernization of IRS tax systems, however, it is not practical to provide details of adjustments and related interest, additions to tax, and penalty amounts on computer-generated notices. Only with full implementation of Tax Systems Modernization would such additional disclosures be feasible.

§ 903. Relief from retroactive application of Treasury Department regulations. Under current law, a taxpayer may rely on Treasury regulations and revenue rulings that accord with the taxpayer's particular facts. In addition, penalties are abated for taxpayers who rely on other written guidance of the IRS. The Secretary may exercise his discretion to issue tax regulations prospectively or retroactively.

The bills would generally ban the issuance of retroactive Treasury regulations. Such an unnecessary limitation would encourage aggressive taxpayer behavior and cause serious administrative problems. The New York State Bar Association and American Bar Association are of the view that, on balance, Treasury has exercised its discretion under current law intelligently and responsibly. Thus, there is no pattern of misuse or other emergency justifying the type of fundamental change contemplated by the proposal.

The prohibition would encourage aggressive return positions in the "window" between the date of change in the statute and the date of issuance of regulations interpreting that change. In addition, the exception for retroactive

regulations to curb abuse of a statute would not cover regulations addressing judicial decisions or substantive defects in prior regulations. The absence of an exception for regulations issued within twelve months of the related statutory provision (as provided in H.R. 11) would encourage the issuance of vague proposed regulations or notices that provide less guidance to taxpayers.

Additionally, the retroactive effective date of the proposal is counterproductive. By applying to regulations filed on or after January 5, 1993, the proposal would undercut legitimate reliance on regulations issued after that date.

March 24, 1995

Chairman JOHNSON. Thank you very much, Commissioner.

We do have four more panels today, and so I want to remind you that your entire statements will be entered in the record and are available to us.

Mr. Monks, if you could direct your comments in such a way that they don't reiterate comments of your colleagues, I would appreciate it.

STATEMENT OF LEE R. MONKS, TAXPAYER OMBUDSMAN, INTERNAL REVENUE SERVICE

Mr. MONKS. Thank you. Madam Chairman, distinguished members of the subcommittee, I am pleased to be here to comment briefly on the Taxpayer Bill of Rights II proposals and to respond to any questions you might have.

As the executive within the IRS with responsibility for administering the Problem Resolution Program on a day-to-day basis, I am in a most unique position. Although I don't have direct responsibility for day-to-day field tax administration programs, I am vitally concerned with how those programs are being administered and how they affect individual and business taxpayers.

One of my primary responsibilities is to ensure that the perspective of taxpayers is considered as decisions are being made and new programs are being implemented within the IRS. In addition, in my role as head of the Problem Resolution Program, I work with our field offices to provide assistance to over 400,000 taxpayers annually who experience problems when normal IRS processes or channels do not seem to work. Perhaps, most importantly, I am also responsible for the Taxpayer Assistance Order Program which was statutorily established by the first Taxpayer Bill of Rights to assist taxpayers who are experiencing significant hardship. On an annual basis, problem resolution works about 33,000 of these cases, more commonly referred to as ATAOs.

In the operation of these programs, a primary goal of PRP, problem resolution, is to identify IRS systems which may be contributing to taxpayer problems. We then work with those segments of the organization that have "ownership" of the process to suggest and make improvements designed to reduce problems of a similar nature in the future.

From an organizational perspective, I report directly to the Commissioner and, therefore, have been provided with a great deal of latitude and independence in accomplishing the mission of PRP. I provide functional direction, guidance, and support to the field problem resolution officers located in every IRS region, district, and service center. Since the vast majority of PRP casework is accomplished in our field offices, it is critical that PRP employees also receive strong support from their local head of office and appropriate functional management.

Today, I would like to share my thoughts on one particular area of the Bill of Rights which I understand is of concern to the Congress, and that is the independence of field problem resolution officers. Although we in the IRS feel that the PRP program is working well as it is currently constructed, and that both the Taxpayer Ombudsman and the field PRO's have been afforded the independence

necessary to accomplish our mission, I realize that many in Congress may not fully share that view.

Based on previously stated concerns in this area, I have given this matter a great deal of thought and would like to propose some specific changes that might alleviate some of your concerns. I must stress that these are my views and suggestions and are not presented as those of the administration, the Treasury Department, or the Commissioner.

First, concerning the Taxpayer Assistance Order Program, current procedures provide that a director, upon appeal, may overturn a taxpayer assistance order and deny relief to a taxpayer claiming significant hardship, based on the facts and circumstances of the particular case. I would propose that taxpayer assistance orders can only be appealed to the Taxpayer Ombudsman. This would address some of the concerns regarding problem resolution officer decisions on hardship cases being overturned by their directors. It would also strengthen the independence of field problem resolution officers regarding decisions relating to taxpayer assistance orders.

Second, concerning the reporting relationship of field problem resolution officers, I am strongly in favor of retaining the current reporting structure to the head of office for district and service center PRO's for a number of reasons. I would suggest the elevation of taxpayer assistance order appeals to the Taxpayer Ombudsman would address most, if not all, of those concerns. A further proposal would be to either designate the Taxpayer Ombudsman as the selecting official for all field problem resolution officer positions or ensure that the ombudsman has significant input into both their selection and annual appraisal. These actions would further enhance the relationship and accountability that currently exists between field problem resolution officers and the Taxpayer Ombudsman while also retaining the high level of support that problem resolution officers receive from their directors.

Field problem resolution officers have expressed their concerns, both to me and to their congressional representatives, regarding the impact of no longer reporting to the local head of office. They feel this could change the positive relationships they have established with their directors and other staff members and possibly impact on their ability to influence decisions and assist taxpayers on ATAO cases. I share that concern. The vast majority of these cases are handled in our field offices on an informal basis. This is due primarily to the positive working relationships established by our problem resolution officers with their functional counterparts. Any change to the current reporting structure could have an impact on those relationships with perhaps unintended consequences. I am of the firm belief that the current reporting structure, with the modifications I have proposed, is in the best interests of continuing our high level of support and assistance to taxpayers. Having said that, we are certainly willing to engage in additional discussions with the committee on this issue.

Earlier, the Commissioner in her remarks indicated I would comment on the proposal to change the ATAO process from taxpayers experiencing significant hardship to the more general standard of experiencing hardship. Problem resolution has already made a distinction in the categories of cases handled by the program. As I

mentioned earlier, we handle over 400,000 PRP cases annually. The general standards on these cases are: Subsequent contact by the taxpayer on the same issue; any contact that indicates the taxpayer has not received a response from the IRS by the date promised; any contact that indicates established systems have failed to resolve the taxpayer's problem; or where it is in the best interest of the taxpayer or the IRS that the case be worked by PRP.

ATAO cases, on the other hand, both have a high standard, significant hardship, and are afforded a higher priority as a result. The essence of the ATAO program is speed and individual attention. Substantially expanding the volume of cases by changing the criteria for an ATAO would inevitably diminish the level of attention and high priority these cases now receive. With over 150,000 ATAO's processed since the establishment of the program in 1989, my view is that the proposed changes would actually hurt those who are in most need of the immediate attention the program provides. Those cases not meeting the higher standard of significant hardship can still be included and receive attention as a regular PRP case.

In conclusion, I fully realize that despite the best efforts of the many hard-working, capable individuals in the Problem Resolution Program, we are not able to resolve every problem in the most timely and efficient manner. There are probably also instances where the program has failed to work as expected. I would certainly invite and encourage you to bring those situations to my attention in order that they may be examined and hopefully contribute to our continuing efforts to improve our services.

I would be glad to answer any questions you may have at this time.

[The prepared statement follows:]

STATEMENT OF

LEE R. MONKS
TAXPAYER OMBUDSMAN
INTERNAL REVENUE SERVICE

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT
HOUSE COMMITTEE ON WAYS & MEANS

MARCH 24, 1995

Madame Chairman and Distinguished Members of the Sub-Committee:

I'm pleased to be here today to make some brief comments relating to the Taxpayer Bill of Rights 2 proposals and to answer any questions you may have.

As the executive within the IRS with responsibility for administering the Problem Resolution Program (PRP) on a day-to-day basis, I am in a most unique position. Although I do not have direct responsibility for day-to-day field tax administration programs, I am vitally concerned with how those programs are being administered and how they may be affecting individual and business taxpayers. One of my primary responsibilities is to ensure that the perspective of taxpayers is considered as decisions are being made and new programs are being implemented. In addition, in my role as head of the Problem Resolution Program, I work with our many field offices to provide assistance to over 400,000 taxpayers annually who have experienced problems when normal IRS processes or channels don't seem to work. Perhaps, most importantly, I am also responsible for the Taxpayer Assistance Order program which was statutorily established by the first Taxpayer Bill of Rights to assist taxpayers who are experiencing significant hardship. On an annual basis PRP works about 33,000 of these cases, more commonly referred to as ATAOs.

In the operation of both of these programs, a primary goal of PRP is to identify IRS systems which may be, inadvertently or otherwise, contributing to taxpayer problems. We then work with those segments of the organization that have "ownership" of the process to suggest and make improvements designed to reduce problems of a similar nature for taxpayers in the future.

From an organizational perspective, I report directly to the Commissioner and Deputy Commissioner and have therefore been provided with a great deal of latitude and independence in accomplishing the mission of PRP. I provide functional direction, guidance and support to the field Problem Resolution Officers (PROs) located in every IRS region, district and service center. Since the vast majority of PRP casework is accomplished in our field offices, it is critical that PRP employees also receive strong support from their local head of office and appropriate functional management.

I have previously shared my views on the Taxpayer Bill of Rights 2 with the committee in writing and recently testified before the committee on IRS efforts to reduce taxpayer burden. Today, I would like to share my thoughts on one particular area of the Bill of Rights which I understand is of concern to the Congress and that is the independence of field PROs. Although we in the IRS feel that the PRP program is working well as it is currently constructed, and that both the Taxpayer Ombudsman and field PROs have been afforded the independence necessary to accomplish our mission, I realize that the Congress may not fully share that view.

Based on previously stated congressional concerns in this area, I have given this matter a great deal of thought and would like to propose some specific changes that might alleviate your concerns. I must stress that these are my views and suggestions and are not presented as those of the Administration, the Treasury Department or the Commissioner.

First, concerning the TAO program, current procedures provide that a director, upon appeal, may overturn a TAO and deny relief to a taxpayer claiming significant hardship, based on the facts and circumstances of the particular case. I would propose that TAOs can only be appealed to the Taxpayer Ombudsman. This would address concerns about PRO decisions on hardship cases being overturned by directors. It would also strengthen the independence of field PROs regarding decisions relating to TAOs.

Second, concerning the reporting relationship of field PROs, I am strongly in favor of retaining the current reporting structure to the head of office for district and service center PROs for a number of reasons which I will cover in just a minute. I would suggest, however, that if there are concerns about the independence of field PROs in the current reporting alignment, the elevation of TAO appeals to the Taxpayer Ombudsman would address most if not all of those concerns. A further proposal would be to either designate the Taxpayer Ombudsman as the selecting official for all field PRO positions or ensure that the Ombudsman has significant input into both their selection and annual appraisal. These actions would further enhance the relationships and accountability that currently exists between field PROs and the Taxpayer Ombudsman while retaining the high level of support that PROs currently receive from their directors.

Field PROs have expressed their concerns, both to me and to their congressional representatives, regarding the impact of no longer reporting to the local head of office. They feel this could change the positive relationship they currently have with their directors and other staff members and possibly impact on their ability to influence decisions and assist taxpayers on ATAO cases. I share that concern. The vast majority of ATAOs are handled in our field offices on an informal basis. This is due primarily to the positive working relationships established by the PROs with their functional counterparts. Any change to the current reporting structure could have an impact on those relationships with perhaps unintended consequences. I am of the firm belief that the current reporting structure, with the modifications I have proposed, is in the best interests of continuing our high level of assistance to taxpayers. We are certainly willing to engage in additional discussion on this issue.

Earlier, the Commissioner, in her remarks, indicated that I would comment on the proposal to change the standard for ATAOs from a taxpayer experiencing significant hardship to the more general standard of experiencing hardship. PRP has already made a distinction in the categories of cases handled by the program. As I mentioned earlier, we handle over 400,000 PRP cases annually. The general standards for these cases are:

- subsequent contact by the taxpayer on the same issue (allowing time to resolve the initial inquiry);
- any contact that indicates the taxpayer has not received a response from IRS by the date promised;
- any contact that indicates established systems have failed to resolve the taxpayer's problem; or
- where it is in the best interest of the taxpayer or the Service that the case be worked in PRP.

ATAO cases, on the other hand, both have a higher standard (significant hardship) and are afforded a higher priority as a result. The essence of the ATAO program is speed and individual attention. Substantially expanding the volume of cases handled in the ATAO program would inevitably diminish the level of attention and high priority these cases now receive. With over 150,000 ATAOs processed since the establishment of the program in 1989, my view is that the proposed change would actually hurt those who are in most need of the immediate attention the program provides. Those cases not meeting the higher standard of significant hardship can still be included and receive attention as a regular PRP case.

In conclusion, I fully realize that despite the best efforts of the many hard-working capable individuals in PRP, we are not able to resolve every problem in the most timely and efficient manner. There are probably also instances where the program has failed to work as expected. I would invite and encourage you to bring those situations to my attention in order that they may be examined and hopefully contribute to our continuing efforts to improve our services.

I would be glad to answer any question you may have.

Chairman JOHNSON. Thank you, Mr. Monks. I will ask a couple of questions and then move on. If we need to come back, we will.

You mentioned at the beginning of your testimony that these were your thoughts and not those of the Treasury, I believe you said. I just wondered if your testimony had gone through the review process of the IRS and the Treasury as testimony traditionally does.

Mr. MONKS. My testimony was shared, but these are my comments.

Ms. BEERBOWER. Treasury did not receive a copy of his testimony in advance.

Chairman JOHNSON. Thank you. Ms. Beerbower, to shift gears just ever so slightly on you, one of the things that is of great concern to me is the whole matter of regulations and when they get written. And from the point of view of taxpayer compliance, I have come to feel this is a very important matter. Could you update us on how many regulations the Treasury and IRS are currently working, what your backlog is? Is the backlog decreasing or increasing? What is the general time lag between when Congress passes a tax law and regulations are written?

Ms. BEERBOWER. Yes, certainly. The IRS and Treasury have announced the 1995 business plan that has on it, I think, about 165—when I last counted it—regulatory projects. Now, these projects are on that plan because all of us, the IRS and the Treasury, are committed to finishing them before December 31.

Last year, I can't remember what our success rate was, but we try very hard to keep track of it. It might have been 85 percent, as I recall, that we completed.

The regulations are of varying degrees of difficulty. Some of them are very easy to write and very easy to issue. Others, such as the regulations that we have issued on contingent debt and synthetic securities and the accrual of income on certain financial products, are very difficult to write. They do take more time, and the lag is obviously greater depending upon the difficulty of the regulation. So it is very hard to say. In some instances, like section 385 in the code, the distinctions between stock and debt, there have never been satisfactory regulations issued.

Chairman JOHNSON. So what is the number of years that is the traditional gap between the passage of a major tax bill and the writing of the regulations?

Ms. BEERBOWER. It would be very hard to say. The OBRA regulations on the conduit provisions, on most of the areas in which significant guidance was needed, were provided last year. So within a year, we attempted to provide at least proposed regulations for most of those statutory provisions. But I think some will take longer.

Chairman JOHNSON. Could you get back to us with precise information on this matter of the gap between when a law is passed, when guidances are issued, and when regulations are adopted and finalized?

Ms. BEERBOWER. Certainly.

Chairman JOHNSON. Thank you.

Mr. Matsui.

Mr. MATSUI. Thank you, Madam Chairwoman.

Mr. Monks, maybe I didn't hear you because I went out for a moment, but did you talk about the abatement of interest issue?

Mr. MONKS. No, I did not.

Mr. MATSUI. What is your position on that?

Mr. MONKS. We have looked at that for quite a period of time, and we believe that there are some instances where abatement of interest may be appropriate.

Mr. MATSUI. So you would favor, then, perhaps something to make changes there to give the IRS and Treasury or both the authority to make changes—or to abate interest, should it become necessary?

Mr. MONKS. I think that it should be looked at on a case-by-case basis. We should take into account the circumstances of the situation.

Mr. MATSUI. In other words, you do favor——

Mr. MONKS. I generally would be in favor of looking at it further.

Mr. MATSUI. What about getting the Service and/or the Treasury Department to lift liens?

Mr. MONKS. I certainly think that there are circumstances where that should be the case, yes.

Mr. MATSUI. Did you speak to that issue in your testimony?

Mr. MONKS. No, I did not.

Mr. MATSUI. I guess the question I want to ask is: How independent are you? How many people do you have working for you, directly under you? Field office, everything.

Mr. MONKS. Directly under me, I have a relatively small staff in the headquarters office, about 25 employees. The field problem resolution officers do not work directly for me. They work for either the regional commissioner, the Service center director, or the local district director.

Mr. MATSUI. Yes. You know, when I was on the city council in Sacramento, we had a situation where we had a city manager form of government, and the elected officials hired the city manager, and the city manager ran the government and basically gave us policy input. And we decided that we needed a little more independence, and we hired a budget analyst, but we didn't give the budget analyst anything but an office. In fact, he had to go out and get his own telephone and all this stuff, and we gave him a little budget. And he failed miserably. I mean, it was the worst situation in the world, and this guy destroyed his career, essentially. He had to move out of Sacramento.

Do you feel you are understaffed? Can you handle your work? Because you have, what, I don't know how many hundreds of thousands of taxpayers you have to handle. I would imagine you receive thousands of telephone calls an hour during the tax season. Is that correct? How do you handle that?

Mr. MONKS. Most of the inquiries go into our field offices. We have about 400——

Mr. MATSUI. But you don't run those offices, though. You don't have any control over those.

Mr. MONKS. I don't run those offices, but I do have a lot of contact with them. They get field direction and guidance from the ombudsman's office. We meet with them——

Mr. MATSUI. But we need an ombudsman, then, because, I mean, the field office is under the direction and control of the Department, right? So, I mean, that is great that they make those calls to them, but what is your function? Do you do the big picture stuff? Do you do the small picture stuff? If an individual taxpayer contacted one of your 25 employees, how do you handle that?

Mr. MONKS. Some of the taxpayer inquiries do come into our office. We work with individual field offices on specific cases. We get information from them. We assist them where they are running into difficulty. So there is a lot of coordination.

Mr. MATSUI. Let me ask, how long have you had this job?

Mr. MONKS. Two years.

Mr. MATSUI. What are your big accomplishments?

Mr. MONKS. We have, I think, made a number of recommendations. One specific project that we worked on in the headquarters office dealt with how to effect improving the processes on changing and updating our master file on taxpayer addresses.

Mr. MATSUI. Was it implemented?

Mr. MONKS. A number of the recommendations have been implemented. We are in the process of monitoring those recommendations to ensure that we do have greater capability in that area.

We are also——

Mr. MATSUI. I guess the question I am going to ask is—well, and you can't answer it, but do you perform a valuable function given your staffing levels and given what you are up against? And if you do, well, then, I don't know how you define it, but if you don't, are you even relevant? And if you need more staffing, then we need to know that. But then that creates—you know, do you have a parallel system? And I don't quite know how you deal with it, but you are kind of in a hybrid position. Who do you represent? Who do you work for? Congress or the executive branch or the IRS or Treasury Department? All these things are a little confusing to me, and I guess when this office was created, those things were thought through. But now that you have been in for 2 years, I would like to kind of pursue this further with you beyond this hearing, obviously.

So that is all I have for you, but I am going to follow up, I guess, with your office to find out exactly what you do.

Mr. MONKS. Certainly.

Mr. MATSUI. Let me ask Ms. Beerbower a question. You indicated—and I tend to agree with you on the burden of proof issue. I think if you really want a system of voluntary compliance, you almost have to put the burden of proof on civil matters on the taxpayer. And so I do tend to agree in a rather strong way with both Commissioner Richardson and you.

The abatement of interest issue, though, I can understand if I got a notice saying that I owe $3,000 but then there was no effort to collect, I will remember that. I will remember even if it is 5 years later. And if I get hit with the $3,000 plus interest, that is my problem and I have to deal with it. But I am not at all sure all taxpayers are in that situation. I can imagine some taxpayers perhaps who live day to day, week to week, month to month, being in a situation where if they got a notice for $1,500 that they owe, they might put it aside, and if there is no collection because, let us say,

the files got lost and 5 years later all of a sudden they are hit with this $1,500 plus interest, they may not be in a position to deal with it.

I don't know how you deal with a situation like that. It just seems to me there is an equitable issue that has to be dealt with, not for me or somebody who perhaps hires a CPA, has an accountant, you know, has the ability and the structure in order to remember those things and think, hey, I might be able to get away with it. But really, you know, if I don't, I am in trouble. But there may be some people that are not in that position. How do you deal with them? Do you make them pay and do you make them sell their house? How is this done?

I think what Mr. Monks says is correct. Maybe you do need a little authority to pick up those cases that are hardship cases.

Ms. BEERBOWER. I think it is a difficult question. As you suggest, it differs case by case, and the individual circumstances of the taxpayer and the facts behind it are critical to one's judgment of whether the relief is necessary or desirable.

I think in situations like that, it is hard to legislate.

Mr. MATSUI. Well, see, I would suggest, I mean, perhaps we give you the authority and you promulgate with the IRS and the ombudsman regulations that would give you some discretion in order to make those judgments. I just don't think it is fair to certain taxpayers, particularly if somebody quits from the IRS, quits their job, and then that file gets misplaced in some cabinet. I don't think that is fair to that taxpayer who may not have quite the background or perhaps the infrastructure to remember those things.

I would imagine there are quite a few of those folks.

Ms. BEERBOWER. I think we would certainly consider the possibility of perhaps publishing standards.

Mr. MATSUI. But you don't have the authority to do anything right now, though; is that correct?

Ms. BEERBOWER. Well, right now what we are doing is working with the staffs on the Taxpayer Bill of Rights, deciding where we need additional authority.

Mr. MATSUI. I am not talking about the staff. I am talking about you don't have the—in other words, there must be taxpayers out there that are in that position.

Ms. BEERBOWER. Yes.

Mr. MATSUI. Now, how do you deal with them? You make them pay, right?

Ms. BEERBOWER. At the moment, I'd defer to the Commissioner on that.

Ms. RICHARDSON. I think that is correct, Mr. Matsui. But also, one of our proposals which would address some of your concerns is to send an annual reminder notice to taxpayers that they do have an outstanding obligation. We are doing this now, but also it is included in the legislation.

Mr. MATSUI. See, in that situation, that is fine. If you were making an attempt to collect, then obviously the taxpayer has the obligation—I don't care what level the income or background of that taxpayer is. The taxpayer owes the money. But there have to be situations where maybe a notice was sent, but then no collection

effort was made for 3 or 4 years, and in that situation, the equity may shift or perhaps the burden of proof should shift in that case.

Why should then the Service put a person in a position where they may have to sell their house in order to collect that back payment plus the interest? It would seem to me you would want the authority to protect those taxpayers. And if we gave you that authority, you can promulgate regulations to deal with the hardship cases, but don't let me get away with it or people in my position get away with it.

I don't understand why you don't want that authority. It would seem to me—I just think that you can't resist all of these provisions. There are some, like the burden of proof, that I think are a problem and that would create tremendous problems for all of you if, in fact, we shifted the burden of proof. We would really no longer have a system of voluntary compliance. But in some cases, it would seem to me that you would want some authority in order to make the proper decision and protect the taxpayer for decisions that are not good.

Ms. BEERBOWER. I think we are certainly willing to consider that. You know, we do work out installment agreements, other types of payment plans for people not able to pay. I would want to study the facts, but I would strongly doubt that the house is taken before——

Mr. MATSUI. Well, let's take somebody making $30,000 a year with 3 kids or 4 kids, a couple of them trying to get through college and they are working part-time. But essentially that person is basically making it month to month, and there are a lot of people like that, I know, in my district and throughout the United States. That person gets hit for $800. You don't collect or attempt to collect for 5 years. That $800 becomes $1,800, you know—I don't know what the interest would be. But that person may not then be in a position to go out and even borrow, and so they would probably have to find some way to put their equity on the line in that house in which they may have $10,000 worth of equity. Then they are going to have a further problem meeting those monthly payments.

It seems to me that there are a lot of people that could be put in that position.

Ms. BEERBOWER. I would certainly consider it.

Mr. MATSUI. I will finish with this comment. I just hope that when you look at these things that you use some discretion, because if you just oppose everything, we may do something that might be bad for you. And we want to work with you. We want some flexibility on your part so that we can come up with a smart decision.

Ms. BEERBOWER. Well, as I was describing in the 40-some-odd provisions that are being discussed now at the staff level, there is major disagreement on only 6. There is massive agreement and modification going on with respect to the balance. I certainly don't want to suggest that we oppose all of the provisions.

Mr. MATSUI. I understand, but this abatement of interest issue seems to me one that you should—I mean, it would seem to me you would want that authority and then you can promulgate regulations and protect yourself but also protect some taxpayers. That is just an example.

Thank you.

Chairman JOHNSON. I would just like to follow up on the report issue so that we may focus on one issue at a time.

Mr. Monks, I know you do provide reports to the Commissioner and that those reports cite problems, operational problems, statutory problems, and make suggestions. In the past, the Treasury has not opposed the provision of these reports to the Congress, and, in fact, we have received in the last 2 years very good reports from Mr. Monks at the request of my honored and esteemed and beloved predecessor, Congressman Pickle of Texas.

But it is my understanding that the Treasury now opposes the provision of those reports to Congress. Is that true?

Ms. BEERBOWER. Honestly, I do not believe we have seen a report from the ombudsman. They are not sent to us. We do regularly communicate with the Commissioner, and the Commissioner will have suggestions that are given to us, and we work on those suggestions to develop legislation where it is appropriate or to embody the suggestion in regulatory projects.

Chairman JOHNSON. Your testimony suggests on page 10 that you oppose the provision of these reports to the committee.

Ms. BEERBOWER. We oppose the provision of legislative tax from proposals going directly from the ombudsman to the committee without the review that is institutional in the Office of Tax Policy—the revenue estimating, the balancing, the input, the conflicts with other provisions—and without filtering that through the Secretary of the Treasury and ultimately the President in order to speak with one voice on tax legislation.

Chairman JOHNSON. I appreciate your concern with the Treasury having a single voice. I hope you will think this over and discuss it with us in the days ahead, because I think there is some merit, frankly, to that discussion going on publicly, to the ombudsman having the responsibility to report things as he sees it to us, and our having the responsibility to work with you and listen. I think certainly the Nation does need one voice on tax policy.

But particularly in today's world, it is important that some of those controversies be discussed and the resolution be a matter of public process. And so I hope you will work with us to reconsider that position on your part.

Second, I do want to mention just to both Treasury and the IRS, I want to raise the issue of the fact that under section 7430, the taxpayer must not only prevail over the IRS on the merits of his case, but he also has to show that the IRS was not substantially justified in maintaining its position against the taxpayer.

We talked earlier in terms of burden of proof, and Treasury gave excellent testimony on how hard it would be for Treasury to prove certain things. It strikes me that it would be very hard for the taxpayer to prove that the IRS was not substantially justified.

What would be your position on switching the burden of proof to the IRS to show that it was substantially justified in maintaining its position in order to defeat a victorious taxpayer's application for attorneys' fees? Now, this is somebody who has challenged the IRS, he has won; it has been adjudicated that, in fact, his case was the better case. Why should he then have to go on to prove that the

IRS was not substantially justified when in this case the IRS has the information and he does not?

Ms. RICHARDSON. Madam Chairman, if I might, I would like to introduce Stuart Brown, who is our chief counsel. I think he is prepared to address that issue.

Chairman JOHNSON. Thank you.

Mr. BROWN. Thank you. Madam Chairman, let me say first that the provision you are describing is our current operating practice; in other words, when our attorneys are involved in a case which leads to a request for attorneys' fees and we decide to oppose the request, our guidance to our attorneys is that they must be prepared to prove the Government's position was substantially justified.

Now, I understand that is not required by statute at the moment, but that is, in fact, the way we operate at the present time. We haven't really considered whether it would be appropriate to enact that into legislation, but we certainly would be willing to discuss that further with you.

Chairman JOHNSON. All right. So you would not have any objection to us clarifying that, in fact, it was the IRS' responsibility.

Mr. BROWN. It is our current practice. I don't think I am prepared to state a legislative recommendation, but I can tell you that is——

Chairman JOHNSON. I think you need to think about that because that is——

Mr. BROWN. We would be happy to work with you on it.

Chairman JOHNSON. That will be of interest to us.

Mr. BROWN. Sure.

Chairman JOHNSON. As you are keenly aware, this month the House passed the Attorney Accountability Act. This bill encourages the settlement of litigation by imposing attorneys' fees on a party which rejects a settlement offer in cases where the court later awards the party less than the amount of the earlier settlement offer.

What would be the IRS' position regarding adopting a similar approach for taxpayer disputes for the IRS?

Mr. BROWN. We would be very careful before we went in that direction for tax litigation, and I guess there are a couple of reasons why. I think you have to remember that attorneys' fees are the tail and not the dog. Our main objective in any tax controversy is to resolve it at the earliest possible level, hopefully, when the questions are first asked by the agent; if not then, through the administrative appeals process; and if not then, in court, in a docketed status. But even though we resolve about 30,000 tax court cases a year, only about 1,000 to 1,500 are actually tried. The others are settled in the process leading up to the trial. And we are concerned that changes that would shift that balance would provide significantly more burden both to us and to the tax court if we do anything that confuses the situation or encourages additional litigation.

Beyond that, if Congress felt that it was appropriate to provide more liberal rules for attorneys' fees, our suggestion would be to make the rules as clear as possible. If you feel it is appropriate that the Government should spend more money to support tax-

payers who want to litigate cases against the Government, the only recommendation I would have is that we should find rules that make that process not interfere with the basic process of resolving the issue on the merits; and, secondly, that in itself, it should not become a major controversy and a source of continuing litigation. But let's just find some rules that are fairly simple and straightforward, and we can go forward from there.

Mr. CARDIN. Would the gentlelady yield on that point?

Chairman JOHNSON. I would be happy to.

Mr. CARDIN. I think this is a very important discussion because many of the cases that you are referring to have implications far beyond the specific case that may be under active consideration, and the IRS position and, indeed, the taxpayer's position may very well be influenced by the impact it has on other cases that are pending. And if we just look at the counsel fees related to a settlement offer and the cost after a settlement offer and the amount of dollars involved, it may not really reflect the importance of that litigation either to the taxpayer or to the IRS.

Mr. BROWN. That is absolutely true. We emphasize over and over again that the reason that we litigate particular cases is not only to collect the proper amount of tax from that taxpayer, but much more importantly, to make sure the rules are clarified and the law is understood and followed by everyone.

So the 1,000 or 1,500 cases that are actually tried to decision in tax court every year are an infinitesimal percentage of the total revenue we collect. The importance of those cases comes from the rules they establish for other taxpayers.

Mr. CARDIN. And, in fact, if you reach settlement you may not even have a clear understanding as to how it impacts on other taxpayers of similar nature if there is a settlement that is not clear as to the effect of it.

Mr. BROWN. I would agree with that. I think that this provision, as I understand this provision, has been available to the Federal Civil Procedure for a fairly long time, and it is only infrequently used in civil litigation generally.

Mr. CARDIN. I would like some time on a different subject.

Chairman JOHNSON. You will have some time.

Mr. Hancock.

Mr. HANCOCK. Thank you, very much. I recognize that this question about the burden of proof is a very, very complicated issue. I just was wondering if there is a way to come up with some type of language which breaks down the responsibility for the burden of proof rather than just saying the burden is entirely on the Internal Revenue Service or it is entirely the individual.

For instance in the cases that Ms. Beerbower mentioned, it is pretty obvious that if you claim a dependent, the burden of proof should be upon the claimant, not on Internal Revenue to prove whether you have the children or whether you do not.

The only trouble is once you start that method or start trying to itemize, especially with our complicated tax law, I am afraid you get into trouble. But it is something we might consider.

One of the things that concerns me is that compliance costs in our system is extremely expensive. There is a lot of money spent

just to comply that could better be spent for better purposes than complying with the tax law.

What about the cases where Internal Revenue obviously makes a mistake. For instance, an individual files the proper papers and everything, and Internal Revenue, in its own system, has the papers, but they get lost. And they end up saying, oh, yes, we are going to send this person a notice of deficiency. We will not give them a name, nobody that they can correspond with, and we are going to send them a little notice that says, you owe us $4,500, a general penalty.

Then that taxpayer has to hire a CPA, or uses his regular CPA or his attorney, whoever the taxpayer is, and files a power of attorney. A month later he still cannot get an answer. He starts trying to make telephone calls, and finds out Internal Revenue says, we will not talk to you on the telephone, we have to do it by correspondence.

Six months later after the individual or the company is out several hundred dollars in fees, Internal Revenue says, ah ha, we found the paper, it was here all the time.

Now, should not there be some way that that taxpayer could be reimbursed for the expenses they have incurred when Internal Revenue had the papers properly filed, the entire 6 or 8 months that they were trying to collect or say that there was a deficiency?

I mean should not the taxpayer have some type of reimbursement other than being able to take his $500 worth of additional attorney fees, or the CPA fees off of his next year's income tax?

Mr. BROWN. Mr. Hancock, if I understand the situation you are describing, I do not think it happens all that often, but it probably happens some times.

Mr. HANCOCK. Yes, it happens some times.

Mr. BROWN. And that when it does happen, I am told that we have some discretion to allow for small amounts to be paid to compensate taxpayers who are in that situation, under section 7430 in current law, as long as they have gotten to court.

Mr. HANCOCK. Well, what if you have a situation though where you cannot even get anybody to agree it ever happened. It happened but nobody says, well, we do not know, everything is OK.

Mr. BROWN. That is a much harder case for us because then we have two different people telling us two different stories.

Mr. HANCOCK. But you are telling me that there is a remedy for this type of situation.

Mr. BROWN. I was not completely aware of it until just now, but I am told that it happens on a fairly regular basis, we do allow small claims like that to be paid when taxpayers can convince us that it really was our fault that something got lost.

Mr. HANCOCK. Can you cite for me the code section that allows that?

Mr. BROWN. I can provide that to you later.

[The following was subsequently received:]

SERVICE'S AUTHORITY TO REIMBURSE TAXPAYERS

Question. At the hearing, Representative Hancock posed the following factual situation and question. A taxpayer files the proper papers, presumably for a correspondence audit, and the Service makes an obvious mistake and loses them. The Service does not provide any person that can resolve the matter and issues a Notice of Defi-

ciency. After the notice, the taxpayer hires an accountant or attorney, who files a power of attorney and tries to convince the Service of its error. Finally, the Service admits its error. The question posed by Representative Hancock was whether the Service could "reimburse" the taxpayer for the expenses.

Answer. As both the Commissioner and the Chief Counsel stated at the hearing, the present formulation of I.R.C. § 7430 allows the Service to reimburse the administrative costs described. Section 7430(a)(1) and (c)(2) address the situation where, after the issuance of a notice of deficiency as described here, costs are incurred. That statute provides for the allowance of reasonable administrative costs where the position of the Service in the notice of deficiency was not substantially justified. Clear administrative errors resulting in an unwarranted notice are obviously not justified. Reasonable accountant or other representative's costs are included in the allowable award amounts. I.R.C. § 7430(c)(1)(B)(iii) and (3). The Service can allow these costs without the taxpayer going to court or the court can require the Service to pay them. I.R.C. § 7430(f) (1) and (2).

The Service has promulgated regulations providing for taxpayer applications for administrative costs after resolution of the merits of the tax liability. Treasury Regulation § 1.7430–2 provides for the filing of the claim with the office that resolved the merits of the tax, or with the district director if the office is not known. The contents of the claim and the procedures for resolving the claim are clearly set forth in the regulations. Treasury Regulation § 1.7430–2(c)(3). These claims are normally handled by the Appeals division administratively following internal procedures published in Internal Revenue Manual (IRM) 8465.

Ms. RICHARDSON. And I think, Mr. Hancock, just to make clear, I think that that provision, as Mr. Brown said, is applicable once a case gets into court. We would certainly be willing to work with you and the staff to try to come up with something that might be equitable through the administrative process.

I think the problem is being able to define a standard that would be workable.

Mr. HANCOCK. Well, naturally they can go ahead and deduct their accounting fees or what have you, but they ought to get the full amount, not just the taxable amount of that deduction. That would make it a little bit more palatable.

Thank you.

Chairman JOHNSON. Mr. Cardin.

Mr. CARDIN. Thank you, Madam Chairman.

Mr. Monks, I am trying to get a better understanding as to how your office operates and I understand that you handle different types of cases, some that are more involved than others.

I would like to concentrate on the TAO's, taxpayer assistance orders. If I understand your written testimony, you receive approximately 33,000 requests a year where the taxpayer has alleged significant hardship. And you have received since the inception of the TAO's about 150,000 requests.

Could you give me some indication of how many of those have led to your intervention and actually issuing taxpayer assistance orders?

Mr. MONKS. The application for a taxpayer assistance order is filed either by a taxpayer representative or by a Service employee when a taxpayer comes to them with a situation that appears to be a case of significant hardship.

We process all of those cases and in approximately 80 percent of the cases have found a form of relief of some sort for the taxpayer.

There are some cases where a——

Mr. CARDIN. A form of relief——

Mr. MONKS. Full relief or partial relief of the circumstances that created the hardship.

Mr. CARDIN. Without the need of formal——

Mr. MONKS. Without the need for the formal issuance of a taxpayer assistance order.

Mr. CARDIN. In those 80 percent of the cases, have you satisfied the taxpayer or you have satisfied yourself that the issue is resolved?

Mr. MONKS. I think both. In the vast majority of the cases, hardship is found and a change is made in favor of the taxpayer.

In some cases, we may not find that significant hardship exists, but it may meet the other criteria for a PRP case and we work that case and try to resolve the issue that led to the taxpayer coming to us.

Mr. CARDIN. And what difference is that from the 400,000 that you handled through the normal routine?

Mr. MONKS. The 400,000 cases refer to our problem resolution type cases. Those cases generally come to our attention as a result of a taxpayer having to contact us a second time on the same issue. Perhaps there has been a system breakdown, perhaps there has been a response promised to the taxpayer that was not made timely. Again, practitioners and Service employees have been trained to recognize those situations and refer those situations to problem resolution.

So we can look at the system that created the problem and try to determine what caused the problem.

Mr. CARDIN. So your 80 percent are screened through informal methods of resolving the problem; what happens to the other 20 percent?

Mr. MONKS. Let me go back. Those are the applications for taxpayer assistance orders.

In some cases the relief cannot be provided and we advise the taxpayer of the action that has been taken to research their account and let them know what the situation is. There are other situations where the relief is denied because it is barred by a statute or it is not the appropriate action to take.

Generally, when a case comes in, we discuss it with the function involved. For example, it may involve a collection issue. We discuss the issue with the taxpayer, and with the collection function and determine the most appropriate course of action to take.

Mr. CARDIN. How many cases actually end up where you have to issue an order?

Mr. MONKS. Not very many. In calendar year 1993 we issued 65 taxpayer assistance orders, and in calendar year 1994 we issued only 12. But again, generally these cases are discussed with the function involved and resolution is reached informally. Let me cite an example involving a collection issue.

We may reach a determination mutually that the case could be resolved better. The taxpayer's hardship can be relieved by granting an installment agreement instead of perhaps a levy on that particular account at that point in time.

So, in many cases, the resolution is reached informally without the need for the filing of a taxpayer assistance order.

Mr. CARDIN. And only 12 cases in 1994 you were unable to resolve the issue with the IRS then?

Mr. MONKS. And the taxpayer assistance order was subsequently issued.

Mr. CARDIN. Well, either you are very, very efficient, or there is not much independence from the agency. You could draw one of two conclusions from that.

Mr. MONKS. Well, what I would like to believe is that the problem resolution officers have been very effective in making their case, because again, on 80 percent of these cases we do provide relief to the taxpayers.

Mr. CARDIN. What standards do you use to issue an order? When will you issue an order?

Mr. MONKS. We would issue an order if we felt that the taxpayer presented a compelling case, we had presented our arguments to the function involved and they did not agree with us, and we felt strongly about the position that we were taking.

We would issue a taxpayer assistance order if we felt that that was the correct procedure to take and that there were no other ways to relieve that hardship.

Mr. CARDIN. And that happens in 12 cases out of 33,000 a year?

Mr. MONKS. That was the case for 1994.

Mr. CARDIN. Thank you.

Chairman JOHNSON. Mr. Monks, I would like to request a copy of the TAO's issued by the ombudsman for my safe, and a summary of the orders that were issued that would be available to the committee.

Mr. MONKS. The orders were issued by problem resolution officers in our field offices, but I can provide that.

Chairman JOHNSON. If you would provide an edited version for the members and then provide the cases, themselves, for the safe, I would appreciate it.

Mr. MONKS. Yes.

Chairman JOHNSON. Thank you.

[The following was subsequently received:]

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

TAXPAYER OMBUDSMAN

April 26, 1995

The Honorable Nancy L. Johnson
Chairman, Subcommittee on Oversight
Committee on Ways and Means
1135 Longworth House Office Building
Washington, DC 20515

Dear Madame Chairman:

At the hearings you conducted on March 24, 1995, you requested that I provide you with copies and edited versions of all Taxpayer Assistance Orders (ATAOs) issued during 1994. At that time, I informed you that there had been twelve (12) TAOs issued during 1994. When gathering the information, it was discovered that one of the TAOs had been incorrectly coded; therefore eleven (11) TAO were issued during 1994. Enclosed are copies of the 11 TAO files and a synopsis of the 11 files with identifying information deleted.

If you have any questions, please contact me or a member of your staff may contact my Executive Assistant, Tom Tiffany. We may both be reached at 202 622-6100.

Sincerely,

Lee R. Monks

Enclosures

TAXPAYER ASSISTANCE ORDERS (TAOs)

1. Case #1

This taxpayer is 73 years old and in poor health. She did not file a tax return for tax year 1991. Based on information reported to I. R. S., we prepared a tax return for her under Internal Revenue Code Section 6020(b) showing social security income of $8,578,00, dividend income of $15.00, interest income $1,711.00, and gross distributions from pension funds of $18,539.00 and $2,009.00. The tax due based on this unreported income is $2,501.00, plus penalties and interest from April 15, 1992. The taxpayer was very upset when she received the proposed tax assessment. She contacted her local office with a Form 911, Application for Taxpayer Assistance Order. I.R.S. did not locate any prior year liabilities. The Problem Resolution Officer (PRO) decided that the taxpayer's situation warranted relief. The PRO set up a meeting with the Examination Division to request the additional tax not be assessed due the taxpayer's age, poor health, and financial situation. Examination insisted the tax must be assessed. The PRO determined that a TAO would be necessary. A TAO was issued, Examination did not contest and the tax was not assessed.

2. Case #2

This taxpayer is 72 years old. She had major surgery three times, 1991, 1992, and 1993. Her only recreation and enjoyment is playing bingo. Her bingo winnings were reported to I.R.S. and additional tax was assessed for tax years 1990 and 1992 by Examination Division. Additional tax was proposed for tax year 1991 by Examination Division. The taxpayer contacted her local office with a Form 911, Application for Taxpayer Assistance Order, because she did not have the ability to pay the additional tax assessed and the tax proposed to be assessed. The taxpayer met with the Problem Resolution Officer (PRO) and gave her an affidavit stating that she spent any bingo winnings on additional bingo games and on auto expenses, etc. to travel to the Indian Reservations where the bingo games were held. She can no longer attend the bingo games as she is elderly, in poor health, and her sister-in-law, who drove her to the bingo games, is now deceased. The taxpayer owns no property and her only income is social security. The PRO determined that relief was warranted. A TAO was issued and the tax for 1991 was not assessed. The tax for 1990 and 1992 was determined to be currently not collectable and will not be pursued.

3. Case #3

This taxpayer owed a joint tax liability for tax year 1982 with her former husband. The taxpayers divorced in 1985 and the taxpayer wife was awarded the personal residence in the divorce settlement. Notice of Federal Tax Lien (NFTL) was filed for the 1982 joint liability, however, the divesting of the taxpayer husband's interest in the personal residence was never recorded. Therefore, the full lien attached to the personal residence. When the Service began seizure action for payment of the taxes due, the taxpayer wife filed a Form 911, Application for Taxpayer Assistance Order (ATAO). The District Office Problem Resolution Officer issued a TAO to settle the matter. The TAO instructed the taxpayer wife to full pay her portion of the 1982 joint tax liability ($17, 233.39), which she did on March 30, 1994 and the NFTL on the personal residence was discharged on July 7, 1994.

4. Case #4

The taxpayer is a clothing business, delinquent on quarterly returns and payment of Federal Tax Deposits and prior taxes. The Revenue Officer has attempted to work with the taxpayer and set up payment plans but the taxpayer has repeatedly not complied. The Revenue Officer was going to seize the business. A TAO was issued to stop the seizure. After review by the District Director, the TAO was rescinded.

5. Case #5

This taxpayer is the mother of new born twins and a 4 year old child. She is single and currently is unemployed and receives only Aid to Families with Dependant Children (AFDC). Her telephone is about to be disconnected and she needs to buy food for herself and her children. Her income tax refund from a prior year is to be offset to a tax liability of her ex-husband. A TAO was issued to provide the taxpayer her refund to purchase food and pay her phone bill.

6. Case #6

This taxpayer is homeless, in desperate need of refund. Currently staying at local motels, one day at a time. There is an outstanding balance due from a prior year. Issued a TAO to provide taxpayer refund and bypass balance due.

7. Case #7

These taxpayers are in need of their refund due to imminent foreclosure because they are 3 months in arrears on the mortgage payments. Their car was stolen with no insurance and recovered with a blown engine. A prior balance due is shown (debtor master file DMF) for child support owed by son who has used father's SSN. Child support enforcement agency verified that this taxpayer does not owe the child support. A TAO was issued to provide a manual refund and bypass erroneous liability.

8. Case #8

This taxpayer suffers from severe depression and has threatened suicide on several occasions. He is responding to psychotherapy and medication. A Revenue Officer set up a wage levy agreement of $543.00 per month which the taxpayer cannot afford. A TAO was issued to reduce the wage levy to $125.00 every pay period ($250.00 per month) so that the taxpayer can afford to continue medical care.

9. Case #9

This taxpayer was a non-filer. Tax returns for 1988, 1989, 1990, 1991, and 1992 were secured with current tax and accruals due in excess of $6,000.00. The taxpayer is 84 years old (as of October 1993). She made an Offer in Compromise which was rejected. She paid $700.00 with the offer. Almost simultaneous to the offer rejection, the Revenue Officer filed a levy on her wages (she was still employed at this time). Because the taxpayer was not given her appeal rights or an appropriate time to respond to the offer rejection, she filed a Form 911, Application for Taxpayer Assistance Order (ATAO). Based on the taxpayers health, age and doubt as to collectability, a TAO was issued to release the wage levy.

10. Case #10

The taxpayers are principals of a Sub-chapter S Corporation with a personal tax liability for tax year 1992 in excess of $39,000.00. They entered into an installment agreement with the Andover Service Center of $1,300.00 per month. The taxpayers requested that no Notice of Federal Tax Lien (NFTL) be filed as they planned to use personal assets as collateral for a loan to pay the taxes. It was evident that the taxpayers had not made adequate estimated tax payments or withholding allowances for the tax resulting from the reported $224,411.00 adjusted gross income

(AGI) shown on their 1992 tax return. Therefore, Collection denied the request and advised the taxpayers that the NFTL would be filed. A TAO was issued to delay the filing of the NFTL until February 4, 1994. The taxpayers agreed to an immediate payment of at least $5,000.00, agreement to a very short term installment agreement, and to furnish I.R.S. with complete financial information (both personal and corporate).

11. Case #11

These taxpayers desperately need their refund which is being offset to the Department of Education for a student loan which the taxpayers claim was repaid in 1984. The husband is currently unemployed and they need the refund to avoid foreclosure on home, continuance of health insurance, and to avoid utilities being disconnected. The taxpayers have a disabled child who needs to be on an electrically powered feeding apparatus 18 hours per day. A TAO was issued to provide refund and bypass Debtor Master File offset.

Mr. Zimmer.

Mr. ZIMMER. Thank you very much, Madam Chairman.

Commissioner Richardson, there was a problem that has been brought to my attention by a police detective who lives in my district. He pointed out that because the mailing label on the forms 1040 include the taxpayer's Social Security number, there is a real possibility of fraud being committed on the part of people who see that label in the mail.

I will not describe the kind of fraud that he said was possible in public, but you can imagine, I suppose. And because he is involved in prosecuting this sort of fraud, he believed that it was foolish for the IRS to include this ordinarily confidential information on a document which is seen by so many people.

Can you explain why the Social Security number is made available in this way?

Ms. RICHARDSON. Mr. Zimmer, we are also concerned about it, and in fact, have been trying to take steps to address it. I think a number of tax packages did not have the Social Security number on the outside this year.

I just became aware this morning of your specific question. I would like to get you the information about what we have done to address it, not just this year, but what we are doing longer term to eliminate that because we are very concerned about it. It is an issue that has been raised.

I think a lot of the problem about addressing it has been a technological one, because of the way our processing systems work. But I will let you know specifically. And we certainly concur with his concerns about fraud. I feel like I know a lot about that subject right now.

Mr. ZIMMER. It is your intention to eliminate this practice?

Ms. RICHARDSON. Absolutely.

Mr. ZIMMER. Can you give us an idea of how soon that will be done?

Ms. RICHARDSON. I will get you the specific information of how we are doing it. Some of it was done this year actually.

Mr. ZIMMER. Thank you very much.

Ms. RICHARDSON. Okay, thank you.

[The following was subsequently received:]

SOCIAL SECURITY NUMBERS [SSN'S] ON LABELS

IRS has received comments from taxpayers concerning the SSNs used on mailing labels for the tax packages. It is our experience that returns filed without the preprinted IRS label contain a high percentage of errors in the entry of the SSN, such as transposed characters and other mistakes. Such errors cause both the IRS and taxpayers unnecessary delays in processing these returns and in issuing any refunds that may be due.

IRS appreciates the privacy concern and is advising taxpayers that IRS mailing labels contain SSN's only when necessary and that the practice conforms to the requirements of the Privacy Act. Nevertheless, because of the privacy concerns raised by taxpayers, we are currently exploring and implementing, where possible, methods to hide or camouflage the SSN whenever technology and production costs permit.

Currently, the SSN is not visible on the outside cover of over 22 million individual tax package postcards, over 7 million individual tax packages and 18 million form 1040ES tax packages. The outside of the tax product contains the taxpayer's name and address and the complete mailing label with the SSN is inside the tax product.

For tax year 1995, the individual tax package postcard program (with the SSN concealed) will be expanded by 10 million. IRS plans to continue to expand the con-

cept of concealing the SSN for all tax packages. However, there are two concerns. First, the production cost of the tax packages will increase. The second concern is with the printing industry capacity for this technology (inkjet image) and the critical paper shortage.

IRS will continue to bid all individual tax package production contracts with the specification for concealing the SSN. And, as long as price increases are reasonable and production capacity exists, IRS will conceal the SSN on all 1995 Individual Tax Packages.

Note: For Tax Year 1994 there were approximately 80 million individual tax packages with the SSN displayed on the outside label.

Mr. ZIMMER. Next, I would like to bring up an issue related to taxpayer compliance. I suppose either the Commissioner or Ms. Beerbower can respond to this. Does the IRS recognize the concept of an accountant-client privilege?

Ms. RICHARDSON. Actually, no, we do not. I will let my lawyer answer that.

Mr. BROWN. No, we do not.

Ms. RICHARDSON. But, no, we do not.

Mr. ZIMMER. So that means that the IRS can request all the documents that are in an accountant's possession, including those given to the CPA by his client, and it would also mean, I suppose, that the IRS could force an accountant to testify against his client?

Mr. BROWN. Yes; that is correct.

Mr. ZIMMER. Now, if the client went for professional advice to a tax attorney, instead, that information would be privileged?

Mr. BROWN. I think it depends on the situation. Give me a minute. I think the answer is that the tax system is not unique in this respect. And we follow the rules that apply in Federal litigation generally, and so, to the extent there is an attorney-client privilege recognized generally in Federal litigation, we would respect that as part of the tax administration process as well.

To the extent that that differs from the privilege that is recognized for accountants, we also follow that difference.

Mr. ZIMMER. Now, does this not have an impact on the ability of people to get their tax advice, their tax planning consultation with a professional of their choice? The exact same information, the exact same services, in many cases, are provided, yet, in one case the communications are protected, and the other case they are not.

Now, I understand the general principal and I understand the attorney-client privilege is more universally recognized, but can you explain the public policy grounding for this position on your part?

Mr. BROWN. I can explain our position only to the extent of saying that we have followed the general principles that apply across-the-board in other Federal litigation.

And, second, we have a principle that we try to stay out of the disputes between the lawyers and accountants over who has the market for providing tax advice. This comes up in a number of contexts over time, including the question of what can accountants do in litigation, particularly in Tax Court. The question of privilege is another aspect of it.

And we generally try not to get put in the middle of those disputes.

Mr. ZIMMER. But your neutrality, in effect, has an impact on taxpayers and the policy, as it exists, would encourage taxpayers to go to tax lawyers rather than accountants.

Mr. BROWN. Let me be clear on this. The attorney-client privilege we recognize is no greater than the attorney-client privilege that we recognize generally.

So, for example, to the extent that you went to an attorney to prepare your return, the information you gave to the attorney for that purpose would not necessarily be privileged.

Mr. ZIMMER. I understand that.

Mr. BROWN. But I think in fairness to your question, there are some differences in the rules. And those rules might benefit attorneys relative to accountants in certain situations. I don't doubt that.

Mr. ZIMMER. Thank you very much.

Thank you, Madam Chairman.

Chairman JOHNSON. I would like to raise the issue of the problems involved in joint and several liability. And Mr. Monks, this surely must touch on many of the problems that you get, but Commissioner Richardson may also have some comment.

Where there is joint and several liability among two or more taxpayers, problems often arise as to which taxpayer is actually morally obliged to pay the debt.

In case of a missing spouse, under current law the incentive for the IRS is to go to the spouse that is quickest and easiest to find. That is often the divorced wife who stayed in the home.

There is no incentive at all for the IRS to find, to locate the other party that may simply be difficult to locate only because they don't bother to respond to IRS letters.

Sometimes this results in tremendous penalties building up and liabilities. Should the IRS be required to at least attempt to locate all jointly liable taxpayers, should they be required by law to try and collect from both taxpayers?

You must see a lot of these cases. I ask this because I see these cases in my district office. I think every Member of Congress does. And there are terrible inequities that occur in these situations.

Have you made any recommendations, Mr. Monks, as to how to deal with them? Is the IRS developing any new policy as to how to deal more equitably in these situations of joint and several, especially when there is often clear evidence of who actually is liable?

Mr. MONKS. We do receive a number of cases of that nature, and, generally, what we try to focus on is that individual taxpayer's specific circumstances. We try to look at their situation and to provide the most appropriate relief.

Chairman JOHNSON. When you say, look at their situation, do you mean looking at their ability to pay?

Mr. MONKS. No, no.

Chairman JOHNSON. Do you mean looking at——

Mr. MONKS. We look at their situation of hardship and what has led to that hardship. And we try to investigate the facts behind that situation. We may end up, as a result, communicating with other IRS offices about that case and what action is being taken.

But you are absolutely correct. A number of situations do come to a problem resolution officer specifically citing those kinds of concerns. I currently have a group in one of our regional offices taking a look at this specific issue. We have had a number of recommendations that have come in from various field offices and

what we are trying to do is to put that together and develop a comprehensive package that we can submit to the Commissioner. It will have more specific recommendations on what the Service might be able to do in this particular area.

It is of concern to us. It represents a major portion of the problems that do come into problem resolution and it is a very difficult situation for us to deal with.

Chairman JOHNSON. Commissioner, do you care to comment?

Ms. RICHARDSON. Yes, Madam Chairman. I think that we clearly should be looking at both taxpayers. In a situation where parties are jointly liable, we should be making equal efforts to try and find both parties. And, clearly, the one who has the best source of leviable income is probably the one we should look at first.

I think this is a good opportunity to mention something that we have begun implementing this year. It is what we call our early intervention program, we are trying to get to people much sooner than we once did. And that, I am hopeful, will address some of the problem.

But it also, I think, is an opportunity to make another commercial for improving our technology. To the extent that we can have up to date records, up to date information, including addresses, and can make on-line changes to that kind of information, we will be in a much better position to locate both of the parties and assure that they discharge their joint liability promptly.

Chairman JOHNSON. I would ask you to accelerate your working groups' focus on this issue. I think this is something that is very important to address because it does touch so many families. Most of them at a time in their lives when they have very, very meager resources.

I also want to put in the record that my office has had excellent success in referring people to your problem resolution officers.

Ms. RICHARDSON. Thank you.

Chairman JOHNSON. And that has been a real Godsend in these cases, both in terms of their timely response, and the fairness of their management of these problems.

So I know that you are making efforts. I just think we need to clean this up and if you could help us on that, the taxpayer bill of rights might be a very good place to attack that.

One last question that I would like to put on the record and then I would be happy to yield to my colleague, Mr. Cardin, if he has additional questions.

Under current law, taxpayers can't appeal collection decisions. And sometimes their first knowledge that there has been a problem is the notice of a lien on their property. Now, this can have catastrophic effects especially if you are a small businessman and you depend on regular revolving loans to fund new orders, and things like that.

And once that lien gets on, they are very hard to remove and it costs money to remove them. There is no notice of deficiency. I really think this issue is very important from the point of view of the taxpayers. It also goes to the resolution of these problematical cases that Mr. Monks office deals with.

People are not satisfied that they never hear back about what did happen in a timely fashion. On that issue of responsiveness, could you comment?

Mr. MONKS. On the issue of the collection appeals matter?

Chairman JOHNSON. Well, and should there be a formal IRS collection appeals process?

Mr. MONKS. We have just concluded a fairly lengthy test of a collection appeals process and a number of recommendations have been made to the Commissioner.

Ms. RICHARDSON. Well, they have not yet been made. They are in the process of being made.

Mr. MONKS. They are in the process of being made.

Ms. RICHARDSON. We hope to be able to make some decisions on that program within the next month or month and a half.

Chairman JOHNSON. I think this also would be a very appropriate focus of a taxpayer bill of rights because there are snarls that are causing real hardship.

Ms. RICHARDSON. It is clearly an area we have addressed in the last 18 months. We have done a test and we are in the process of evaluating it. We will be getting those recommendations in the next month or so and making a decision.

We will be happy to share those conclusions with you.

Chairman JOHNSON. I hope you also will consider allowing taxpayers to seek injunctive relief if they haven't had notice. So that they can stop a process that is destructive to them if they feel they have not been a part of resolving it.

I look forward to hearing from you on those issues, and I yield to Mr. Cardin.

[The following was subsequently received:]

IRS WILL SHARE CONCLUSIONS ABOUT COLLECTION APPEALS TEST AT LATER DATE

Commissioner Richardson is in the process of reviewing the report of the Collection Appeals Test and is considering recommendations. We will share our conclusions with Chairwoman Johnson as soon as they are available.

Mr. CARDIN. Thank you. Just for the record, I would ask the IRS and the Treasury to give us some ideas or thoughts on how we could expand the opportunity under the taxpayer bill of rights.

I think the taxpayer bill of rights is going to move legislation in this area. There seems to be strong bipartisan support for the legislation. But, perhaps this is also an opportunity to move forward in two other areas which you have both mentioned and which are important to taxpayers.

That is modernization, as well as tax simplification. I would be curious as to whether you would have some recommendations—I am not asking you to respond now, but to think this over and respond if you would later—as to some specific provisions that we may be able to include in the taxpayer bill of rights legislation to focus in on procedures to simplify the Tax Code with regards to common complaints by taxpayers, as well as providing the wherewithal to modernize the capacity of the IRS.

And if you could get back to us on that I would appreciate it.

But the second point, if I might, following up on Mr. Zimmer's point, I think it would be useful for us to know when we could expect Social Security numbers to no longer be on mailing labels. So

if you could get back to us with the specific date on which that practice would be terminated, I think that would be helpful for us.

[The following was subsequently received:]

DATE FOR REMOVAL OF SOCIAL SECURITY NUMBERS FROM MAILING LABELS

The IRS will be able to conceal the SSN on all 1995 Individual Tax Packages as long as price increases are reasonable and production capacity exists.

Chairman JOHNSON. I thank the panel for your participation this morning, your good testimony, and for your agreement on a lot of the things we are trying to do. We did not spend much time on the areas in which we are in agreement that we can move forward and I thank you for that agreement.

We will be submitting some additional questions for the record. We just do not have time to get to them today. And we will look forward to your answers on that, and we will look forward to your follow-up on some of the things that you are working on that we believe will fit into our work.

Thank you very much.

Ms. RICHARDSON. Thank you, Madam Chairman.

Chairman JOHNSON. The next panel will come forward, Jeff Jaeger of the Rutherford Hill Winery, from Napa Valley, Calif.; Georganne Howden, Houston, Tex.; Richard Beck, professor of law, New York Law School.

And we will start with Mr. Jaeger.

STATEMENT OF JEFF JAEGER, MANAGING GENERAL PARTNER, RUTHERFORD HILL WINERY, NAPA VALLEY, CALIF.

Mr. JAEGER. Madam Chairman and members of the subcommittee, my name is Jeff Jaeger, and I am here to talk about some IRS tactics used on my family's business that I consider to be extremely unfair treatment that makes honest taxpayers angry at government and those who created the system.

My company, Rutherford Hill Winery, is in the fine wine business in California's Napa Valley. We consider ourselves a small business, and although it may sound glamorous, it is very hard to make a profit in it.

The profits become simply impossible when we must spend $85,000 in attorney's fees to beat an insupportable IRS tax assessment, then are denied the recovery of $70,000 of those tax fees in court.

We have been audited by the IRS before several times. We have never lost a dime to the IRS when we have been audited because our tax accounting systems are sound.

In our recent tax court case, the IRS conceded every single item that they had assessed against us, but we still lost big money on the attorney's fees because of the coercive and deceptive practices of the IRS.

The main tax issue in our tax case was about our single pool LIFO (Last-in-first-out) inventory valuation method. It is the same method we had used from our beginning, 15 years earlier; the same method used by many of our competitors, including our sister winery, that cleared an IRS audit the same year with an identical LIFO situation; and a method that reflects income as well as any

other inventory or valuation method there is for our type of business.

According to tax law, the choice of the LIFO method is a taxpayer's. The IRS agent assigned to our case liked other pooling methods and wanted to force her choice on us.

Her approach was not only novel, but it created serious disagreement even within the IRS. However, she was allowed to send us the equivalency of a deficiency assessment notice. In saying this, I recognize that the Internal Revenue Code gives the Commission broad authority to change a taxpayer's accounting method if it does not clearly reflect income.

But the Code does not permit the Commissioner to order a change simply because an IRS agent thinks that a different method might reflect income more clearly. That, however, is exactly what the IRS was trying to do here.

Partway into our preparation of the tax court case, two issues unrelated to the LIFO issue were conceded to us by the IRS but not before we spent serious money getting ready to defend them.

It has now become clear that the IRS never intended to litigate our case at all. The agent on our case and her IRS cohorts were trying to force a different inventory valuation method on us, one that was neither accurate nor practical.

The agents were using the IRS's current protective shield against recourse to try and intimidate us into submission, even with an unwinable tax case, knowing it would cost us dearly to defend ourselves.

This is government gamesmanship at its worst. It was the agent's hope and the hope of her cohorts to pick on a few wineries, get them to concede, and then use those concessions, as they would use a tax court case, to coerce other wineries to change their methods to those preferred by the agents.

It is only natural that the IRS would not want to pick on too many wineries at once for fear that the wineries could join together and better defend themselves. Instead the agent used the old "divide and conquer" technique even without a legally supportable test case.

The fact we know now is that the IRS would not, in fact, could not possibly have gone to trial with our case. That does not mean that we knew of their intentions earlier. We had to assume there would be trial and we had to prepare for it. That preparation was extensive and expensive. We now feel like someone who had been held up by a man with an unloaded gun. Not only were we robbed, we were deceived as well.

Our case may sound as though we were an unlucky taxpayer singled out as a guinea pig by the IRS in its efforts to create government-favored retroactive tax law. While the practice of allowing the IRS to get pro-government court opinions, after the fact, is always unfair to tax planners, that is not what happened to us and not why I am here today.

The IRS was far more sneaky than that in our case. For us, the IRS proposed a tax adjustment that it could not possibly substantiate. Its proposed changes were so seriously flawed that it knew it could not dare to go trial.

Knowing there would be no trial, the IRS attorneys made no real trial preparations, but kept up a pretense that they were ready for trial.

The sole reason the IRS attorney kept the case alive was their hope we might concede enough to give the IRS an appearance of victory which it could then use to coerce concessions from other taxpayers.

Because present law makes the recovery of attorney's fees virtually impossible in tax court cases, no matter how ridiculous the Service's case, IRS agents and attorneys had no fear of proceeding with their "mission impossible" case against us. They faced no prospect of losing money, no consequent exposure of the bureaucratic bungling and chicanery, no risk at all in proceeding with their extortion plan against us, because in the end they would be accountable to no one. It was a no-lose proposition for them; it was a no-win proposition for us.

With the law, the way it is written now, we decided that pursuing an appeal to get our attorney's fees would likely be throwing good money after bad. It is never easy to get an appellate court to reverse a tax court decision and when the tax court reads the law to say that the position of the IRS is substantially justified in virtually all instances, no matter how far-fetched, and unfounded the IRS' legal theory may be, then the taxpayer stands no chance at all of getting reimbursement for attorney's fees. We thought it better to bring the case here, to this committee, in the hope that Congress would be more inclined to see that justice is done for the taxpayer when the IRS proceeds in bad faith.

Currently the Congress is searching for a way of dealing with the unfairness of the American legal system, where winners must now shoulder their own legal expenses, even though they win their case. To extend that search for fairness to legal actions involving the Government is only logical and just. The opinion in our tax court case denying us attorney's fees is not only another nail in the coffin of justice, but it is also a masterpiece of bureaucratic double talk.

The Service was well served, but justice surely was not. On behalf of businesses nationwide, my hope is for a change that would award attorney's fees to a petitioner in tax court any time the IRS answers the petition, reaches no settlement with the taxpayer, then fails to take the case to trial.

Furthermore, I hope Congress will seriously consider establishing a presumption, if not a rule, that attorneys' fees will be awarded to a taxpayer any time that taxpayer wins his tax court case.

Thank you.

Chairman JOHNSON. Thank you for your excellent testimony. It is sobering.

Ms. Howden.

STATEMENT OF GEORGANNE HOWDEN, HOUSTON, TEX.

Ms. HOWDEN. Thank you. Chairman Johnson, thank you for having me here. I feel my story is kind of simple. In 1985, I was divorced after 21 years of marriage. I was a high school graduate and married early and had kids early and never worked outside the home.

I never saw or signed a tax form. My husband made the money and he did not think it was my business to know what money he made or how he dealt with it.

In 1985, I filed for divorce and I got a job in retail. In 1986, in December of 1986, I got a notice from the IRS of some tax due and it was $600 or $400. It was in the hundreds of dollars.

I asked my attorney about it. At that point I wrote a letter to the IRS stating that I was in the process of divorce, that I was still in the family home, what his address was, the attorney's and mine.

My divorce was final in 1987. In that divorce my house was awarded to me. It was filed in the district court clerk's office. My attorney told me to file it in the property records and the tax records in Harris County. I also sent a certified copy of my divorce decree that stated the house was mine, to my mortgage company.

That was in September 1987. In January 1988 I went with my divorce lawyer down to the IRS because during my divorce I became aware of tax liabilities. I went down to the IRS and met with an agent there. And showed my divorce decree and she asked that I try to borrow money on the equity in my home. I went to three banks to do it, and it was kind of a bad time in Texas right then.

And with my lack of job history I was unable to do that. I also filled out the forms necessary, giving all my financial information. I was awarded this status of uncollectible.

At that time, the decision I made was because I had a son at home, 11 years old, and he wanted to stay in the house he had grown up in. And so we decided to try to make it there.

So a month at a time we stayed in the house, and because the only thing I had gotten from my divorce of any value was my home—I was unable to collect on the other things that were awarded—I thought, well, I'm putting a lot of money in the house, but I can get it out when I sell it, you know.

So I planned to keep it until he graduated from high school and then, at that time, sell my house—4 years passed. The only thing that happened that I got notification from, from the IRS, in those 4 years, was in 1991.

That was the first year of 3 years that I received notice that my $1,000 refund on my income tax was being applied to another person's Social Security number. And I assumed it was my husband's.

So I thought, well, that is fair. I am uncollectible, they can have my refund. In December 1991, I received a call on my answering machine from the problems resolution officer in Austin, Tex., which is our capital.

And it scared me to death. So I talked to a friend and he recommended a tax counselor, who is accredited with the IRS and he was a retired IRS officer of 30 years or something.

So I went down and hired him because I couldn't afford an attorney to counsel me. We had a series of meetings going over my problem.

And what we came up with during those months was I could either get an attorney and go to court, or I could sell my house. But the problem that came up when he talked to the IRS in Austin was they were going to take the house for the taxes from my marriage, but also my ex-husband had not filed any taxes in the years I had been divorced.

And they decided that somehow they figured out he owed $100,000 in income tax, and the IRS was going to take this stance. They said that the house was still his. And if they took that stance, it would take every bit of the equity, plus some, but then I would also end up owing about $15,000 in capital gains tax. So it was a lose-lose kind of deal for me.

In July 1992, I came home from work and found this seizure notice on the front door of my house. I had decided to sell my house after talking with my tax consultant, and see if the IRS would not be reasonable about his taxes.

So I had a for sale sign out and the seizure notice on the front door which does not do much to sell your house. And that was a shock. I had had no notice of this.

The next month I was in Austin and I decided to go and see the tax collection group manager who was handling this case. I happened to be in town, and I thought what do I have to lose?

So I went to see him and to discuss my problem with him. It was not very long after I arrived I found out that my case had turned into a personality issue not a principal issue.

And that my ex-husband had made him very angry. He said because my house records were not filed, my divorce records were not filed in the Harris County clerk's record, that he considered the house still joint property.

When I said, I would like to sell the house, because I knew I could gain more money that way in a forced sale. He said, you sell it, we are glad you do that, we will get more money.

He told me a lot of information about my ex-husband I did not know and said he would deny ever telling me that. He discussed his personal problems, but at the end of the conversation—and I listened like a lot of women do hoping to get some compassion—he said, you are going to lose it all and you just start all over again, and your capital gains you can pay out over time.

I was really in a no-win situation and though I am shaky, I am OK about all this today. In August 1992, the Republican Convention was being held in Houston, Tex., and I was fortunate to run into Donna Steele of Congressman's Archer's office.

And when she heard my case she was interested in looking into it and taking action for me. We started a long series of written communications. I was shocked that the IRS was so casual in their response to Congressman Archer. And it certainly made me realize I would have been wasting my money if I could have gotten an attorney, if they would not pay any attention to Congressman Archer.

The IRS held the position that the IRS was not a notified creditor, that they did not know about my divorce. And, in fact, I had gone in, personally, and showed them my divorce decree and it was filed everywhere that it was required in Houston.

In December 1992, the district director wrote and said he would take the proceeds of any voluntary or forced sale of my house for my ex-husband's $100,000 in current taxes, plus the amount of the 1992 taxes still owed from my marriage.

All through this process I was kept uninformed. I was never informed of any negotiation with my ex-husband toward the community debt from 1992. It felt real familiar, similar to my marriage.

November 1993, I got a call from an IRS office, saying that if I would pay all of the 1992 taxes, which was approximately $20,000 plus pay $10,000 additional they would release my husband's taxes off my home.

The problem I had with this was that I did not have any resources to come up with this kind of money because I could not sell my house because it was seized. So it was kind of a circular problem.

I, at that point, called my ex-husband—we do not communicate—in order to ask him if he would be willing—I had a judgment of unpaid child support for $50,000—and I asked him if he would be willing to buy that from me. That was my focus of the phone call.

At that point, he told me that a few months earlier he had made a settlement with the IRS. My ex-husband has a master's degree in engineering and he works for an engineering company. He has a home in Houston, a farm outside of town, cars, trucks, and an airplane.

He made a settlement with the IRS that they said he owed $99,286 so they asked him to pay $150 a month. And he thought it was a little foolish that I was having this trouble, that I could not resolve it. He sent me a copy of that.

I notified Congressman Archer about that discovery and think that that was probably the spark to the tinder. Congressman Archer wrote a very strong letter to the IRS and sent me the answer. Once again, I was amazed. They did not bother to answer most of his questions.

But they did say that out of respect to him they would release me from my tax liens if I would pay $17,600. So that is $15,000 in interest, and $3,500 in the 1982 tax that was due.

This was signed by the district counsel, the problem resolution officer, and the chief of the collection division. Two weeks later, I wrote the district counsel requesting a closure. I received no answer. That was December.

I was struggling with how to come up with the money and in March 1994, Mr. Archer suggested that I call the local Houston problem resolution officer, and try to set up a meeting. I got immediate response from them.

How I had managed to come up with money was that I sold my $50,000 child support judgment to an attorney for $17,500. I had a meeting with the IRS on March 28, 1994, and I was told I had a right to offer and compromise.

I filled out the papers. At the meeting 2 days later I was told I had no right to offer and compromise. That I had to pay the $17,500.

I paid the $17,500 and the 1982 taxes and I was told that I would receive a release of my home within a few days. This was March and I hoped to be able to sell my house during the summer when the sales are better. I was able to maintain my house until my son went to college, but after that it became very difficult to make ends meet.

And my credit rating was not the best. I am a real slow payer sometimes. I had to wait 5 months for that discharge. It came in August.

I lost the window of opportunity for sale for that year. Because I am in sales I do a little better over Christmas, so my house is on the market today. The problem resolution officer in Houston said that I could apply for a refund of some of the penalties and interest which I did do under her direction and her assistance. And she also included a letter of her struggle for the 5 months to get my house released.

For 5 months I received no answer. I resubmitted the letter. I got a call from the IRS that said I need to reapply on a different form but there was not really any reason to because they never refund.

I do plan to go forward with this. And without the intervention of Congressman Archer I would have a very, very sad story to tell here today. And I have found out that I am not the only person who has had this problem. And I do hope that I will be heard for not only myself but for others.

The system really did not work for me. Thank you.

Chairman JOHNSON. Thank you, Ms. Howden.

Mr. Beck.

STATEMENT OF RICHARD C.E. BECK, PROFESSOR OF LAW, NEW YORK LAW SCHOOL, NEW YORK, N.Y.

Mr. BECK. Madam Chairman and distinguished members, I am Richard Beck and I teach tax law at New York Law School. I appreciate very much the opportunity to be here and speak.

I have studied the problem of spousal tax liability for many years. I have written articles about it. I have worked with the American Bar Association about it, and I can tell you that the testimony you have just heard here is not an unusual case at all. It is very common for women to get stuck with their ex-husband's tax bills.

I have not been able to find out exactly how common it is because the IRS tells me they do not keep statistics. I once estimated that there are at least 10,000 cases a year in which collections were made from the wrong spouse. I think I was off by an order of magnitude. I now think there are probably from 50,000 to 100,000 cases a year.

To try to keep things short here, I disagree with some of the testimony that we heard earlier. I do not think that the answer to these problems is to improve the procedures for relief. I think the better approach is to cut the Gordian Knot completely, and end all spousal liability.

There is no reason in my opinion and in the opinion of the American Bar Association, ever, for one spouse to be liable for the taxes on income earned by the other spouse.

It should just be ended. I would like to point out that no other country in the world imposes this sort of liability. We are alone here in both kinds of liability that were suffered by Ms. Howden. Both joint and several liability for joint returns and community property liability for one-half of the other spouse's income are both virtually unknown in other countries.

Taking the easiest one first, the *Poe* v. *Seaborn* community property liability, there are many community property countries in the world. Not one of them uses family property law to impute income for tax purposes from one spouse to another, not a single one.

Canada had the same problem. They have a community property province in Quebec, and a gentleman there tried to do what Seaborn did here some 28 years before, and the Supreme Court of Canada came to the opposite conclusion. Spouses cannot split their income, each spouse is liable solely for the tax on his or her own earnings. I think that is the rule that we should have; we should repeal *Poe* v. *Seaborn*.

As for joint and several liability on joint returns, that rule dates from 1938 and there never was any good reason for it. The only reason the Treasury gave when it asked Congress for the rule after it lost in court, in 1935, was that it could not tell on a joint return whose income was whose, and therefore both had to be jointly liable for the full amount.

Now, that problem does not exist. In almost all cases it is very easy to determine whose income is whose. We have rules for that. And there were rules for that in 1935 when the Cole decision was made.

And even worse, at the very time that the IRS was saying it could not make these determinations it was, in fact, arguing that charitable contributions on joint returns should be limited by the separate income of each spouse on a joint return. In other words, the IRS knew full well how to separate the husband's income from the wife's income on a joint return when it was good for the government.

I would urge you to consider enacting the American Bar Association's proposal to end spousal tax liability. We have been considering these issues now for seven years in the ABA Tax Section. It is true that the innocent spouse rules could be improved in many ways, but we finally concluded that there is no principled place to draw a line.

The innocent spouse rules have been amended twice. They still do not work. The IRS now has the authority to ignore the husband and pursue the wife, even if the husband is readily available and has the money to pay. As long as the IRS has this authority, I think we can expect unfairness.

The law itself is unfair, not just the way it is administered. I would urge you to adopt the American Bar Association's proposal which is very, very simple. It does not affect tax rates. It does not affect joint returns. It does not affect any other issue except the apportionment of liability. And the only times when it would be necessary to make an apportionment is when there is a disputed deficiency for an unpaid tax.

In other words, everything would go on as it does now, except in a case when the IRS asks a spouse to pay a deficiency. That spouse should always have the right to say, I want to be assessed strictly on my own income.

I think it should be a fundamental right of all taxpayers to be taxed solely on their own incomes. Thank you very much.

[The prepared statement follows:]

STATEMENT OF PROFESSOR RICHARD C.E. BECK

In Support of Repeal of Spousal Joint and Several Liability for Income Taxes under IRC § 6013(d) and under *Poe v. Seaborn*

I. Joint Returns. Section 6013(d) requires joint and several liability of the spouses if they elect to file jointly. More than 98% of married taxpayers file jointly each year, because filing separately usually results in a higher tax. The incentive is all but irresistible, and joint filing has aptly been called "mandatory in fact." Thus virtually all married taxpayers are subject to joint return liability.

The statute itself is gender-neutral, but it appears that the vast majority of collections from the "wrong" (or non-earning) spouse are from women. The figure would be over 90% if the litigated innocent spouse cases reflect the general percentage of all collections.

This liability is aberrational when compared to tax systems in other countries,[1] even those which also provide valuable tax benefits to married persons filing jointly.[2] No other OECD country taxes wives for their husbands' income as a general rule, much less women who are separated or divorced.[3] Under U.S. law, by contrast, thousands of separated and divorced women each year are taxed for no other reason than that they were married at the time their ex-husbands earned income.

The rule of joint return liability was first enacted in 1938. Until then, filing jointly (which had been allowed since 1918) did not entail joint and separate liability of the spouses, despite the government's insistence to the contrary. See *Cole v. Comm'r*, 81 F.2d 485 (CA-9, 1935), *rev'g* 29 B.T.A. 602 (1933).

In *Cole*, the Ninth Circuit held that a taxpayer's cardinal right to be taxed only on his own income was unchanged by joint filing, and rejected the government's argument that administrative necessity requires joint and several liability, at least where the respective separate incomes of the spouses are ascertainable. The government argued that because joint returns do not explicitly set forth the respective separate incomes and deductions of the spouses, it would be unable to determine the separate amounts for which each spouse should be liable.

This purported "administrative necessity" was the only reason put forth in the committee reports when Congress overruled *Cole* by enacting the predecessor of Section 6013(d) in 1938. Yet the argument is palpably insufficient. There is ordinarily no difficulty in determining each spouse's net income on a joint return. The audit process almost necessarily reveals the source of any asserted deficiency.[4] Moreover, such determinations are in fact sometimes required under

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[1] For example, no marital liability for income taxes is imposed in any form in Canada, Australia, Japan, Italy, Spain, Sweden, or the United Kingdom.

[2] Cf. Germany, which provides for income-splitting computed as under U.S. law, but without joint and several liability, and Belgium, which has a still more generous system of income-splitting.

[3] In France, joint liability is imposed in principle, but wives who are no longer living with their husbands at the time of enforcement proceedings are nearly always excused. Also, unlike U.S. law, in France the tax authorities must exhaust all possibilities of collecting from the husband before turning to the wife. In the U.K., husbands were formerly liable for tax on their wives' income, but wives were never liable for their husbands' taxes. This system was abolished in 1990 in favor of completely separate liability for both spouses.

[4] There was no such difficulty in the *Cole* litigation either; the Bureau of Internal Revenue had simply assessed the husband by mistake, and negligently let the statute of limitations run as to the wife. In case of doubt, the IRS can always assess both spouses, and let the taxpayers

current law in order to limit the amount of each spouse's separate losses which may be carried forward or back to offset his or her share of income in a joint return year, and in order to calculate the amount of each spouse's separate right to a refund from a joint return.[5] The method used is to calculate each spouses's separate net income as if he or she had filed separately. There are adequate rules under current law for apportioning personal deductions and dependent exemptions for this purpose.[6] Over 2,000,000 separate returns are filed each year by married persons, with no apparent difficulty.

Adequate reasons for imposing joint and several liability have never been provided. There is no evidence that couples ordinarily share all their property to such an extent that they should be presumed indifferent to the incidence of tax liability. And even if such sharing were the norm, it could not justify joint liability after termination of the economic unity of the family by divorce.[7] Contrary to widely held belief, joint return liability was not enacted as the "price one must pay" for lower tax rates on joint returns. The favorable tax rates for joint returns computed by income-splitting were not introduced until 1948, some 10 years after enactment of joint return liability.[8] Moreover, the right of spouses to offset deductions and losses against each other's income and gains had been available to taxpayers from 1918 until 1938 without the "price" of joint and several liability. Joint returns were introduced in 1918, apparently for the sole purpose of convenience both for taxpayers and for the government, without any thought of special rates or privileges for married persons.

The quid-pro-quo justification for joint return liability is as weak logically as it is historically. The size of the benefits of joint filing (if any) bears no relation to the joint return

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prove the sources of their income, as the *Cole* court pointed out.

[5] See Rev. Ruls. 80-6,7,8; 1980-1 C.B. 296 ("separate tax method of allocation" applied to refunds; and for losses see Rev. Rul. 60-216, 1960-1 C.B. 126; Rev. Rul. 65-140, 1965-1 C.B. 127; and Rev. Rul. 75-368, 1975-2 C.B. 480.

Similar rules were in effect at the time of the *Cole* litigation, as well as other regulations (later invalidated) which required the same determination of the separate net incomes of the spouses for the purpose of limiting each spouse's charitable contributions and capital losses on joint returns. The Treasury has apparently never experienced any difficulty administering these rules. They all worked to the Treasury's advantage, however. The government's litigating position in *Cole* was thus at best uninformed, and was possibly in bad faith.

[6] The current rules are as follows: Business income and deductions are allocated to the owner(s) of the business. Investment income from community property and jointly owned property is divided equally between the spouses, even if one spouse actually receives all the income. Items of personal deduction (such as medical expenses) which are paid out of community or jointly owned funds are ordinarily divided equally between the spouses, but items paid out of separately owned property are normally deductible only by the payor spouse, even if the payment is for a joint obligation. (The limitations as to such items, such as the 7.5% floor on medical expenses, are separately applied to each spouse.) If the taxpayer can prove that the funds used were his own, however, he will be entitled to the entire deduction even when payments are made out of a joint account.

[7] Application of Section 6013(d) liability against separated and divorced women seems to be an unintended consequence of the original enactment of the general rule of joint return liability. Not one of the half-dozen cases litigated before its enactment in 1938 involved separation or divorce. The IRS seems to have developed its aggressive position in this area in the 1960's, during the post-war explosion in divorce rates. This social development could not have been foreseen in 1938.

[8] Income-splitting was not enacted as compensation for assuming joint return liability, but for the entirely different purpose of equalizing the tax burden between the common law states and the community property states, where income-splitting was already allowed on separate returns under the doctrine of *Poe v. Seaborn*, 282 U.S. 101 (1930).

liability assumed, which may be unlimited in amount. The benefit explanation cannot justify joint liability for an amount greater than the tax saving from filing jointly.

Finally, the "benefits" usually inure to the husband, while the liability almost always is borne by the wife. Joint return liability is not only unfair in principle, it is highly discriminatory against women in fact.

Innocent Spouse Rules. Congress enacted the "innocent spouse" rules under Section 6013(e) in 1971 in order to mitigate the harsh effects of joint return liability. Under these rules, a wife may be relieved of liability for tax items of the husband only if they are "grossly erroneous";[9] they cause a "substantial understatement;"[10] the wife did not know, and had no reason to know of the substantial understatement caused by such items ("innocence");[11] and taking into account all the facts and circumstances, it would be inequitable to hold the wife liable for the understatement ("equity").[12] The wife has the burden of proof as to all the elements for relief.

The relief rules are unsatisfactory in two respects. First, they limit relief in many deserving cases due to the arbitrary restrictions to "grossly erroneous" items and to "substantial understatements," and second, they are vague and unpredictable due to the nature of the "innocence" and "equity" requirements. There is a large body of case law interpreting the innocence requirement,[13] but the decisions are in conflict,[14] and the outcomes are largely

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[9] An item of omitted income is "grossly erroneous" per se. Erroneous claims of deduction, credit, or basis may also qualify for relief, but such items must in addition be "without foundation in fact or law." This phrase has severely limited relief for such items. Mere disallowance of a deduction does not qualify. There is no relief for simple nonpayment of tax where the return is correct; relief is in effect limited to items of negligence and fraud. There is no obvious reason for these limitations, and they have the somewhat bizarre effect of putting the wife in a better position if the husband misreports than if he reports honestly.

[10] There are dollar limitations under Section 6013(e)(3) and (4) restricting relief to items exceeding $500, and in the case of erroneous claims of deduction, credit, or basis, the item must in addition exceed 10% of the wife's pre-assessment year income if $20,000 or less, or 25% if her income exceeds $20,000. For these purposes, if the wife has remarried, her current husband's income must be included in the floor whether or not they file jointly.

[11] Factors which have been used by the courts as indicating that the wife had "reason to know" include lavish or unusual expenditures, involvement in the family budget or the husband's business, and higher education or business experience. The courts have not applied these factors consistently.

The cases are split as to whether the wife has a duty to review the return. Compare e.g. the recent tax shelter decisions in *Cohen*, 54 T.C.M. 944 (1987) and *Shapiro*, 51 T.C.M. 818 (1986)(taxpayers lost) with *Hinds*, 56 T.C.M. 104 (1988) and *Killian*, 53 T.C.M. 1438 (1987)(taxpayers won).

The wife has sometimes been held to have "reason to know" if she is aware of the existence of the underlying transaction, even if she knows nothing of its tax consequences or how the husband reported it. This doctrine that "ignorance of the law is no excuse" is without foundation in the statute.

[12] The principal factor considered under the equity test is whether the wife benefitted from the item over and above ordinary support. The courts have been extremely inconsistent as to what this means. Note, too, that because all elements for relief must be met, the wife may lose even if she did not benefit at all, if she is found to have had reason to know of the item.

[13] There are over 400 reported decisions under Section 6013(e), and the confusion grows ever greater. A considerable simplification would result if the relief rules could be repealed together with joint return liability.

unpredictable.[15]

The arbitrary limitations could be adequately reformed by amending the statute to omit the dollar limitations and the requirement, in effect, of negligence or fraud on the part of the husband. But there is no way to amend the innocence and equity tests, because they are essentially misconceived.[16]

The "innocence" test is at the heart of the relief rules.[17] But this test is illogical and inappropriate as a basis for relief. Ordinarily a reason to know (or due diligence) test is applied in the context of assessing whether a person who is in a position to prevent foreseeable harm to others has breached his duty of care. But the wife has no duty to certify the accuracy of her husband's tax items, except as created by the innocent spouse rules. Women generally do know that they have any such duty of certification,[18] and do not act as if they did. In countless instances, the wife simply signs the return as an accommodation to her husband.[19] And if she refuses, she may risk her marriage.

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[14] A particularly glaring conflict is presented by the "ignorance of the law is no excuse" doctrine. This doctrine seems to have been selectively applied only against women who are still married at the time of trial.

[15] At least as to the stated grounds of decision. It appears that many of the inconsistencies in the reported decisions can be accounted for by supposing that unconscious preferences of the judges have been at work. It appears that divorced women who had been housewives or who fulfilled traditional roles of dutiful dependency have fared better in the Tax Court than independent and educated women. Higher education and business experience have no obvious relevance to whether the wife had reason to know of the husband's understatement, but they are routinely treated as factors unfavorable to the wife.

[16] The reason for most of the defects in 6013(e) is that the rules were narrowly drafted to track the *ad hoc* reasoning used by the Sixth Circuit to nullify joint and several liability in a spectacularly unfair case. In *Scudder v. Comm'r*, 405 F.2d 222 (1968), *rev'g* 48 T.C. 36 (1967), the husband had embezzled large sums from a business owned by the wife and her sisters, without their knowledge. The IRS pursued her for taxes (including the 50% fraud penalty) on the embezzlements, and won in the Tax Court. The Sixth Circuit simply refused to apply the law, and exonerated the wife on the ground that she could not have intended to file jointly as to these fraudulent items, where she did not know of them, and did not benefit from them.

The Sixth Circuit's ingenious approach allowed it to do justice in the case at bar at a time when no statutory relief at all was available. But the relief was crafted to fit unusual facts, and it was inappropriate for Congress to use this narrow *ad hoc* device as the basis for general statutory reform.

[17] The importance of the innocence test is perhaps due to an intuitive perception that joint return liability is itself simply unfair. To the extent that the liability can be rationalized as somehow due to the wife's own fault, liability can be imposed in a manner less troubling to the conscience.

[18] It appears that very few taxpayers are, or have any reason to be aware of this assumption of liability. There is no warning on the Form 1040. Nor does it appear that preparers or divorce lawyers generally take this liability into account. Even if a wife is aware of this "duty," the penalty for breaching it is unfair. If a professional return preparer or an IRS agent fails to use due diligence, he does not become liable for the tax deficiency he could reasonably have been expected to discover on someone else's return. And yet such persons have both tax expertise and awareness of their professional duties, upon which the IRS does reasonably rely.

[19] When the duty of due diligence is pushed as far as it was in *Bokum*, it in effect requires the wife to seek a second professional opinion in all cases.

Such a requirement is not only unrealistic and unreasonable, it also defeats the original purpose of joint filing, which was to provide convenience to both the taxpayer and the government. It is unreasonable to expect both spouses to duplicate the effort of preparing the return, particularly if only one has income, or any complexity to his tax affairs.

In short, it makes no real difference at all to the government's interests whether the wife is innocent or not, nor whether she makes any effort at due diligence when she is "put on notice." For that reason, there is no underlying purpose or principle to guide the courts in weighing the variety of factors used to determine degrees of "innocence."

Under these circumstances, it is not surprising that the various legal "tests" have in large part degenerated into a global subjective one of whether the woman and her plight can move the judge to sympathy. It is obvious that taxation should not depend on such subjective criteria, and for that reason the innocent spouse rules cannot provide the remedy for the unjust effects of joint return liability.

Effects of Repeal of 6013(d). In order to institute a regime of elective separate liability for married persons, no other changes will be required. The current rate structure and system of filing statuses can remain unchanged, and the benefits of income-splitting for joint filers can be preserved. The separate liability of each spouse will be calculated according to the "separate tax formula" cited above. First each spouse's tax is calculated as if he or she filed separately, and then the ratio of wife's separate tax to the sum of both separate taxes is applied to the total joint tax due. In this way the benefit of the income-splitting rate structure is preserved, but the wife is liable only for the portion of the joint tax which is due to her separate income.[20] The formula is thus:

sep. liability = (sep. tax / both sep. taxes) x joint tax

Calculation of the wife's separate tax liability in the first instance will not require any changes in current law.

II. Abuse Potential. There would appear to be no abuse potential in repeal of joint return liability. Whatever abuse potential might arise from repeal of joint return liability would appear to exist already under current law. A couple planning to avoid the husband's taxes while leaving the wife with property not subject to tax can simply file separately. If there were any abuse potential here, it would already be exploited.

If joint return liability is repealed, the IRS may be expected to rely upon transferee liability under Section 6901 as a substitute. Although transferee liability will not apply in many cases where Section 6013(d) currently does apply, transferee liability should be adequate to police any potential abuses. Establishment of transferee liability for taxes depends upon state law of fraudulent conveyance, or federal bankruptcy law, where applicable. This will usually require the IRS to prove that the husband was insolvent at the time of a transfer of property to the wife, or that he became insolvent as a result of the transfer, and that the property was transferred without adequate or fair consideration. Where there is inadequate consideration for the transfer, it is presumptively fraud and there is no need to prove actual fraudulent intent on the part of either the debtor or the transferee.[21] Transferee liability can therefore apply under current law even if the wife is an innocent spouse within the meaning of IRC 6013(e).[22] Even if adequate

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[20] This calculation will not increase the complexity or difficulty of preparing returns, because it will only be employed on audit in cases where there is a deficiency which is contested by the wife.

[21] See e.g. *Mysse v. Comm'r*, 57 T.C. 680 (1972)(transfer of $10,000 C.D. to wife without consideration set aside where embezzler husband was insolvent at time of transfer because unassessed tax liability of over $115,000 from unreported income exceeded his total assets of $46,429. (Montana law)).

[22] In *Mysse*, the wife was held to be an innocent spouse with respect to IRC 6013(e) because she had no actual or constructive knowledge of the embezzlements, and received no significant benefit beyond ordinary support. She was nevertheless liable as a transferee for her husband's

consideration supports the transfer, however, if the wife is aware of or participates in her husband's fraud on his creditors, the transfer may still be set aside as fraudulent.[23]

Transferee liability cannot apply unless the husband is insolvent and unable to pay at the time of attempted collection, as well as at the time of the transfer. Thus if the IRS is restricted to exclusive reliance on transferee liability because joint return liability is unavailable, that will automatically have the desirable effect of forcing the IRS to exhaust all remedies against the husband before proceeding against the wife. In addition, transferee liability is limited to the amount of the transfer, and therefore (unlike liability under Section 6013(d)) the wife's liability cannot exceed the amount by which she was benefitted.

Finally, under transferee liability the wife is not at any unfair disadvantage compared with other transferees. All transferees are treated alike under Section 6901, without regard to marital status. By contrast, 6013(d) applies only to spouses. Children, parents, and even an adulterous girlfriend may receive gifts out of the husband's untaxed income, even with actual knowledge of his tax cheating, without incurring any liability (provided that the husband is solvent). Wives alone incur a liability in this situation.

I do not claim that transferee liability will be a complete substitute for joint return liability. Some situations will inevitably arise where the IRS will not be able to recover property of the wife which is in part derived from untaxed income of the husband. It seems unlikely, however, that such situations will arise frequently or will present a problem serious enough to require a remedy in anticipation, and none is suggested here.

It is well to remember that every other modern country manages to collect its taxes without reliance on joint and several liability.

III. Community Property Liability. A wife who resides in a community property jurisdiction is subjected to liability for one-half of her husband's taxes under the doctrine of *Poe v. Seaborn*, 282 U.S. 101 (1930), which construed family property law in the community property states to create a separate liability of each spouse for one-half of the tax on the income of the other on the theory that all earnings during marriage inure to the marital community, and are therefore owned by and taxable to each spouse in equal amounts. This form of liability does not depend upon filing a joint return, and results automatically from residence in a community property jurisdiction.

The *Seaborn* decision was very questionable when decided. Under community property law generally the wife has no right to spend or otherwise dispose of any part of her husband's earnings.[24] Her "ownership" rights to such income arise only upon dissolution of the marital community by divorce or death, and then only to such income that the husband has not already spent.

The *Seaborn* decision arose in the context of rates rather than liability, because the wife was willing and eager to accept liability in order to reduce her husband's taxes through income-splitting. The question was whether the wife had the right to report half of her husband's income on her separate return, rather than whether she had the duty to do so. It was not long before the IRS seized upon the decision to construct such a duty, however, and the result was a number of very harsh decisions requiring divorced women to pay half of their ex-husbands' taxes in

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taxes to the extent of the transfer.

[23] See e.g. *Wilkey v. Wax*, 225 N.E. 2d 813 (App.Ct.Ill. 1967) and *U.S. v. Alaska*, 661 F. Supp. 727 (N.D.Ill. 1987).

[24] This is still true even under the modern dual-management community property regimes. See Smith, *The Partnership Theory of Marriage: A Borrowed Solution Fails*, 68 Texas L.Rev. 689 (1990).

situations where they had received no benefit from his earnings.[25] A woman cannot protect herself from this form of liability even by filing separately, unless she first dissolves the community of property.

Apparently, no other income tax system in the world today except the U.S. imputes earned income from one spouse to the other on the ground of community property law,[26] including Spain, France, and Mexico, from which our state community property laws derive. In Canada, a situation arose which was identical to that in *Seaborn*, and the Canadian Supreme Court reached the opposite conclusion interpreting Quebec community property law. Because the husband had the absolute right to dispose of his earned income as he pleased, he must be taxed on it despite the wife's contingent rights under the community property regime.[27]

Still more surprising is the fact that at least two community property states, Arizona and California, reserve the right for state income tax purposes to tax either the earner for the full amount, or the community property owner for one-half. Thus the federal tax system defers to state matrimonial property law where the state's own tax law does not.[28]

Relief Under Section 66. There are relief provisions under IRC 66, first enacted in 1980, for the innocent spouse which provide limited relief from community property liability analogous in many respects to relief under IRC 6013(e).[29] The rules are far too restrictive, and have often failed to prevent obviously unfair results. Nearly all petitioners for relief under Section 66 have lost. It is revealing to note that when Section 66 was enacted, its revenue cost was estimated to be "negligible."

Section 66(c) (enacted in 1984) contains the same requirements of "innocence" and "equity" which are criticized above in connection with Section 6013(e). The innocence test is nearly impossible to meet under Section 66, because if the wife knows her husband was employed, she loses. Two other provisions allow relief without proof of innocence, but they

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[25] See *U.S. v. Mitchell*, 91 S.Ct. 1763 (1971). The Supreme Court noted the harshness of the result, but said the law was clear and the only remedy was legislative action similar to the newly enacted Section 6013(e). Enactment of Section 66 was nine years in coming, and probably would not have protected the wife in *Mitchell* any event.

The *Seaborn* briefs did not anticipate that the government might someday use the rule as a sword against non-earning wives. The anti-taxpayer use of the rule seems wholly unintended.

[26] Countries which ignore their community property law for purposes of taxing earned income include Canada, Germany, Belgium, the Netherlands, Sweden, and Italy, as well as France, Spain and Mexico.

[27] See *F.Sura v. M.N.R.*, 62 D.T.C. 1005 (1957)(Quebec taxpayer not permitted to split his income with his wife through community property law; *Seaborn* rule rejected)

[28] If it had been thought necessary to respect the matrimonial property law of the community property states for purposes of taxing earned income, the result should probably have been as it was generally in Europe in the early part of the century: mandatory joint returns with the husband primarily responsible for payment as sole administrator of the community property. See generally Dulude, *Taxation of the Spouses: A Comparison of Canadian, American, British, French, and Swedish Law*, 23 Osgood Hall L.J. 67 (1985). This would have been a far more realistic interpretation of community property law than the *Seaborn* decision, which imputed half of the husband's earned income to the wife. Also, it would not have created the intolerable disparities in the level of tax burden between the states which arose in consequence.

[29] Before enactment of the relief provisions, at least one court refused to apply the rule of *Seaborn* to avoid the "horrendous" result that the wife was "stripped clean" by the IRS though she had received none of his income. In *Bagur v. U.S.*, 603 F. 2d. 491 (1979), Judge Wisdom remanded the consolidated appeals to the Tax Court to determine whether the wives had suffered the equivalent of theft losses of their share of the community income.

suffer other shortcomings. None of the Section 66 provisions provides any relief for items other than omissions of income. Section 66(a) provides relief only if the couple lived apart at all times during the calendar year, and none of the earned income in question was transferred between them. Even one day of cohabitation during the year, or payments of support which are not *de minimis*, will preclude relief.

Section 66(b)(enacted in 1984) provides that the benefits of community property law may be disallowed to any taxpayer if he acts as if solely entitled to the community income, and fails to notify his spouse of the nature and amount of such income before the due date for the taxable year. The "benefit" here is the husband's relief of liability for one half of his earnings. This provision may be defeated if the husband notifies the wife of her liability, even if he gives her nothing.

Repeal of *Seaborn*. There is no doubt that Congress has the authority to overrule *Seaborn*, and it has already done so in many limited contexts.[30] The *Seaborn* rule has never been applied at all for purposes of the payroll taxes (social security and hospital insurance) and for the tax on self-employment income. Also, in 1976, Congress in effect repealed the *Seaborn* rule for couples one or both of whom are nonresident aliens.

The *Seaborn* rule now provides no benefit to taxpayers, and is advantageous only to the government.[31] This is a ironic in view of the fact that the *Seaborn* doctrine arose as a device to benefit residents of community property jurisdictions. This benefit was jealously guarded by representatives of such jurisdictions when repeal was attempted in 1940 (by means of proposed mandatory joint returns, without joint and several liability) in order to equalize the tax burden among the states. But since the 1948 introduction of income-splitting on joint returns for all married persons, the *Seaborn* rule no longer provides any advantage to taxpayers, and there should be no opposition to its repeal from the community property states.[32]

III. Effect on the Tax System. Neither repeal of Section 6013(d) nor repeal of the *Seaborn* rule need have any effect upon current tax rates nor filing statuses, and none is recommended here. These proposals for separate tax liability are put forward on their own merits for the sake of fairness and simplicity.

Revenue Cost. The IRS keeps no statistics on the frequency or amounts of collection from the non-earning spouse. It is therefore difficult to estimate the revenue loss from repeal of

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[30] Many sections of the Code contain provisions which are to be applied "without regard to community property laws." Among these are Section 32(c)(2)(B)(i) [earned income credit]; Section 402(e)(4)(G) [lump-sum benefits]; Section 408(g) [individual retirement accounts]; Section 414(d)(4)(A) [limitation on cash method of accounting]; Section 457(d)(7) [deferred compensation plans of state and local governments]; Section 911(b)(2)(C) [foreign earned income]; Section 4980(d)(4)(A) [excess distributions from qualified plans], and, of course, Section 6013(e)(5) [innocent spouse rule] and Section 66 itself.

[31] Except for a husband who may escape tax on half of his income. Note that this is a complete escape, since the wife has no right to contribution from him for her payment of his taxes, as she does in the case of joint return liability.

[32] Repeal of *Seaborn* would of course have no effect on community property law itself, and no recommendation is made here as to any issue of state family property law.

Note that even after repeal of *Seaborn*, women subject to community property law will remain under a tax disadvantage, because the husband's community half interest in her earnings is a property interest within the meaning of Section 6321 and subject to levy even for his antenuptial tax debts. Thus one-half of the wife's earnings may be levied upon to pay *all* husband's taxes even where she has no personal liability for them under *Seaborn*. See, e.g. *Medaris v. U.S.*, 884 F.2d 832 (CA-5, 1989).

6013(d) or *Seaborn*. It is probable that the loss (if any) will not be large, because often the husband is available to pay, and the wife is taxed only because her assets are more easily accessible to levy. In such cases, there may be an added cost of collection, but no revenue loss. In other cases, transferee liability would apply. In some instances, the Treasury will even profit from repeal.[33] In the community property states, some husbands report only half their income and force the government to collect the remaining half from an absent wife. Repeal of *Seaborn* would end this practice. Some revenue loss is probably inevitable, however.[34] But it must be borne because the government's revenue needs cannot justify taxing the wrong taxpayer in amounts bearing no relation to ability to pay.

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[33] For example, under current law a wife may actually escape tax on her *own* earnings by achieving innocent spouse status under Section 6013(e). This seems to have occurred in *Price v. U.S.*, 887 F.2d 959 (CA-9, 1989).

[34] The expected revenue loss should not estimated by simply writing off all potential assessments under Section 6013(d), because many such assessments are unrealistic or illusory. The IRS often assesses huge deficiencies on insolvent taxpayers (typically, but not limited to narcotics dealers and embezzlers) where it is obvious that the deficiency cannot be collected from either spouse. See, e.g. *Ratana v. U.S.*, 662 F.2d 220 (CA-4, 1981).

Chairman JOHNSON. Mr. Beck, do I understand you to say that everything the IRS did in the *Howden* case was legal? It was legal for them to ignore that she owned the house, and legal for them to ignore that he did not?

Mr. BECK. I do not know the details of that aspect of it. I cannot speak to that part of it.

Chairman JOHNSON. But the IRS does not have the right to ignore legal documents governing property ownership, do they?

Mr. BECK. That is correct. If they had some——

Chairman JOHNSON. But they do have the right or they do not have the right?

Mr. BECK. No; they do not have the right. I do not know the facts of what went on in this case.

Chairman JOHNSON. Right. I appreciate that you do not know the facts, but the law does not give them the right to ignore legal ownership, does it?

Mr. BECK. It does not. But even if the house belonged entirely to Ms. Howden, if she had a personal liability under *Poe* v. *Seaborn* to pay half of her ex-husband's taxes, that is a personal liability of hers and her own separate property can be levied upon to pay it.

So, again, I do not know the facts, but even the fact that it is entirely her house does not answer the question. Joint and several liability and *Poe* v. *Seaborn* liabilities are personal liabilities of the taxpayer that can be satisfied out of the separate property of the taxpayer, not necessarily out of joint property.

Chairman JOHNSON. Thank you.

Mr. Jeager, your testimony was very vivid and we will certainly review it and see what we can do about the IRS operating under startingly different assumptions in some cases than in others. I appreciate your taking the time to be here with us today and to go through your experience with us.

Mr. JEAGER. Thank you, Madam Chairman.

Chairman JOHNSON. You indicated in your testimony that the IRS never intended to actually take your case to Tax Court. What makes you think the Service did not intend to litigate?

Mr. JEAGER. Well, firstly the IRS used information from our filed tax returns in determining our deficiency notice. And when we had a chance to review their information the numbers they used in their computations were incorrect, and did not reflect the accurate numbers that we had on a similar tax return that we had in our possession.

On several occasions we invited the IRS to sit down with us, to correct their misinformation and they never responded. We were trying to give them the precise numbers, and they were unwilling to take the time to review their information with us.

We could not understand why they would not meet with us and had to assume they were only trying to drag us along until we would settle. And never really having the data that they needed to win in that court case.

Second, to further illustrate this fact, only a few weeks before trial one of our attorneys was having a discussion with the lead agent for the IRS who advised us for the first time that work papers, and I quote, "There were several serious computational er-

rors," in their work papers of the agent who did the audit of our business.

If the IRS was serious about going to trial and knew it had the burden of proof, it surely would have revised its computational errors before bringing the matter to the court, and to our knowledge, no such corrections were ever prepared.

Third, they were to file with the court, on a certain date, their expert witnesses with no witnesses being designated. With none available and inaccurate information it became increasingly obvious to us that they had never intended to try the case.

Chairman JOHNSON. To gain attorney's fees you would have had to prove that the IRS was not substantially justified in bringing their case. How hard would it have been to prove this? How much access would you have had to those figures?

Mr. JEAGER. It is extremely difficult. As the lawyers explained it to me the Tax Court—I am sorry, could you repeat the question?

Chairman JOHNSON. Under current law in order to get attorney's fees, which you would like to do and anybody in their right mind would want to do under these circumstances, you would have to prove that the IRS was not substantially justified in bringing the case.

How difficult would it be to prove this?

Mr. JEAGER. Well, it is extremely difficult. It is extremely difficult, Madam Chairman. As the lawyers explained it to me, the Tax Court says that no matter how marginal of the IRS' chances of success may be in bringing a case before the Tax Court, and no matter how burdensome and expensive it may be for the taxpayer to defend itself, the IRS' position is still substantially justified.

If that is the hurdle that a winning taxpayer has to clear to get its attorney's fees reimbursed then the taxpayer is almost going to win in its motion for litigation costs.

Chairman JOHNSON. Thank you very much, Mr. Jeager.

I am going to yield to my colleague, Mr. Cardin, and come back.

Mr. CARDIN. Thank you, Madam Chairman.

Let me thank all three of you for your testimony.

Mr. Jeager, your case is certainly one that disturbs all of us, that you had to go through the type of litigation costs in a case that, from your testimony, was rather straightforward and a practice that was long standing within the industry, which had not previously been challenged, and where there was no indication of any justification for the challenge.

I am having a hard time though understanding what happened in your case and why you were unable to successfully recover your costs, including counsel fees.

The Tax Court, you made a request to the Tax Court for costs and were denied because you could not establish that the Federal Government was not substantially justified in the position?

Mr. JEAGER. That is correct. That is accurate. I mean it is our opinion that no matter how small of an opportunity that the IRS has to extract money from the taxpayer, so to speak, they are substantially justified. And that substantially justified to us is unreasonable.

I think the true definition of substantially justified needs to be addressed.

Mr. CARDIN. Well, the legislation that has been filed in this Congress takes a different approach and I would like to get your views as to whether you think that would be effective or not.

It does two basic things. It first allows you to get information about your case from the IRS in order to be able to help the court in determining whether there was substantial justification in the Government's position.

And second, the legislation increases the dollar amount of the counsel fees which you can be awarded. I believe those are the two changes that are in the Taxpayer Bill of Rights II.

Do you believe that would help you in being able to recover your fees?

Mr. JEAGER. Well, you know, yes, I believe it would help. I mean I honestly think I would like to take it a further step. I think the law should require that the IRS take reasonable—and I use that word very hardly here, and very succinctly—because reasonable positions, they need to take reasonable positions before the tax court and it should be defined in a common sense fashion.

I mean as IRS legal theory that has a marginal chance of success and it is not reasonable and the law should so hold. I further think that when the IRS concedes a case, in its entirety, prior to trial the law should treat that the same as if the IRS had gone to trial and lost.

And I believe that in both those situations, the winning taxpayer should be reimbursed for their attorney's fees. The spirit of the current Congress is that government keeps its commitments with the American people and lives by the same standards and reasonableness and fair play that are supposed to be at the heart of our legal system.

I believe that that was the first law you passed shortly after this Congress convened. I want to make clear that I am not here solely to ask that businesses like mine get back some of the money they have expended on attorney's fees. That certainly would be fair, but there is another, larger good to be served by making the IRS act in a more reasonable manner.

The sure prospect of having to pay a winning taxpayer's litigation costs would incentivize the Service to pick and choose its cases more reasonably and responsibly, and the American people would be better served by having the IRS use its resources in that more efficient and effective manner.

Mr. CARDIN. Mr. Jeager, I am very sympathetic to your problem and think that we need to change the system so that in your type of case, you are able to recover your costs.

Mr. JEAGER. And my fellow wineries, as well, my fellow businesses that are in the same predicament that I am.

Mr. CARDIN. Right. I understand that. Let me compliment you on the product you produce. It is a very good product.

Mr. JEAGER. Thank you on behalf of the wine industry.

Mr. CARDIN. The concern I have is that the standard passed by the Congress would appear to be a rather generous standard to the taxpayer, would appear to be. So, because it requires the government to substantially justify its position. If I understand the IRS position today, they are willing to assume the burden of that proof,

where they would have to come forward and prove that their position was substantially justified.

That appears to be a pretty strong standard that the Government must meet. It is certainly different from the frivolous lawsuit standards which we use in typical lawsuits for the litigant to be able to recover costs.

So I am somewhat puzzled as to why the Tax Courts are imposing such a burden on the taxpayers, when Congress has already spoken to provide a mechanism for the taxpayers to be able to recover costs against the Government. That is what we intended in the Taxpayer Bill of Rights I.

I understand your position, and we certainly need to take a look at this to make sure that people who are put in a wronged position by the government are able to recover their costs.

Mr. Beck, I understand your position very well. In particular, it is troublesome in cases where spouses are no longer living together or living in a less than harmonious circumstance.

Are you concerned at all if we eliminate all joint liability that where a husband and wife are living together, that they may be able to concoct some form of property ownership that the government may not be able to get at in an effort to try and avoid tax liability, because one spouse earns the income, and using a joint-type of an ownership of certain properties in order to avoid paying their taxes?

Mr. BECK. I have devoted a lot of thought to that and so has the ABA and we all concluded that there is very little abuse potential in this for various reasons.

First is that under current law you can do all this anyway by just filing separately. You can avoid joint liability by just filing separately. It usually costs a little more in taxes, which is why people file jointly.

But if you could avoid taxes on any scale that was significant, people would be doing it right and left, because it does not cost all that much extra to file married filing separately.

That is the easy answer. The longer answer is that——

Mr. CARDIN. You have not seen any significant abuse by married taxpayers filing separately so that they can avoid joint liability, and then filing——

No. I do not think so.

And then you also have transferee liability that applies. If one spouse makes himself judgment proof by giving property to the other spouse, or to anyone else for that matter——

Mr. CARDIN. A little more difficult to establish though. Your first argument was very good; your second one I am not so sure transfers.

Mr. BECK. True. It will not apply in every case and there are hurdles. The IRS would have to show insolvency and you are quite right, it is not automatic. It is not a complete substitute.

Mr. CARDIN. But you convinced me on your first point. The first point was a good point. I am finished, thank you.

Chairman JOHNSON. I want to quickly run down a series of questions, Ms. Howden, since we do not have your testimony in writing. They are easy and it will not take long. We do have this vote coming up and we will adjourn between panels and go vote.

But as I understand it the deficiency asserted by the IRS related to your 1982 joint tax return. Did you sign that return?

Ms. HOWDEN. No, I did not.

Chairman JOHNSON. Did you qualify for the innocent spouse protections under the law.

Ms. HOWDEN. I was told that I did not because I was able to enjoy his income.

Chairman JOHNSON. Did the IRS ever attempt to contact you during the process of assessing the deficiency on your 1982 return?

Ms. HOWDEN. No, no.

Chairman JOHNSON. When did you first learn that the IRS had filed a lien against your house for the 1982 deficiency?

Ms. HOWDEN. When I found the seizure notice on the front door.

Chairman JOHNSON. So that was in what year?

Ms. HOWDEN. That was 1992.

Chairman JOHNSON. Did the IRS inform of any efforts it was taking to collect the taxes due on the 1982 return from your former husband?

Ms. HOWDEN. No, they did not. And when I asked for that information they said it was privileged. That they could not disclose what they were doing with him.

Chairman JOHNSON. I understand that your former spouse was permitted by the IRS to enter into an installment payment plan with the IRS. How much was he asked to pay, do you know that?

Ms. HOWDEN. He was asked to pay $150 a month on a $99,000 judgment or debt owing. He pays $150 a month.

Chairman JOHNSON. That is $150 a month on a $99,000 debt. Do you have any rough idea what his income is?

Ms. HOWDEN. I do not know. I imagine close to $100,000, I would think.

Chairman JOHNSON. Does he not own a couple of houses and an airplane?

Ms. HOWDEN. Yes. They seized one airplane but he has another one.

Chairman JOHNSON. But they settled for $150 a month on a $99,000 debt. Were you given the same opportunity?

Ms. HOWDEN. No, Ma'am.

Chairman JOHNSON. So you had to come up with how much did you say on how much debt?

Ms. HOWDEN. That was $17,500.

Chairman JOHNSON. On a $17,500 debt. In cases where a joint return has been filed, do you think the IRS should be required to give both parties who signed the return the opportunity to participate in the appeals process before the assessment, when the joint return is made final?

Ms. HOWDEN. I absolutely do. And on every occasion I told them I was willing to take responsibility for our joint debt.

Chairman JOHNSON. I will tell you, I have been in elective office almost 19 years now, and we have dealt with a lot of these cases in my office. And many of them arouse outrage. I have never heard such an outrageous story as yours today. I have never seen the IRS literally torment a single parent, struggling to support a child, for as many years as they have tormented you.

And believe me this case will drive one section of the Taxpayer Bill of Rights, with Mr. Beck's ultimate assistance.

And Mr. Jeager, I hope that small businessmen in America, when we get done writing a Taxpayer Bill of Rights, will be far more secure and far safer from the kind of attack that was launched against you and your business.

And if Mr. Hancock would like to make any comment or ask any questions, I would be happy to yield to him.

Mr. HANCOCK. Thank you, Madam Chairman.

About the only thing that I would say is that this has been building for the past 50 years, and it is going to come to a head one of these days.

And I am glad to see that we are holding a hearing and finally recognizing that, yes, we do have a problem. That IRS has a specific problem. There are people out there that will try to defraud. But this situation of rogue agents going after somebody and not exercising any judgment must be addressed. Otherwise, we will have more and more situations where people say, look, if they are not going to be fair, then I am not going to even attempt to pay my fair share.

This situation of Mr. Jeager. In your particular situation, you could afford the $80,000. I mean you are going to be able to stay in business.

There are a lot of small companies that would go out of business under these same circumstances. In fact, that has happened.

There has to be a balancing act, and I am glad to see that we are finally getting around to it. I would recommend a book to you, "The Good and Evil of Taxation." Pick it up and read it and that will tell you exactly what we have got to accomplish.

Thank you.

Chairman JOHNSON. Just as our system depends on the great majority of Americans, paying the amount of tax that they owe voluntarily, and fairly accurately, our system of problem resolution has to start from the assumption that the vast majority of people who have tax problems are not trying to defraud the Government.

Certainly some are and we have the capability to go after fraud where fraud exists. But the number of innocent Americans that become the victims of our tax system has simply got to be reduced. We made some efforts to do that in the 1988 law, we made some efforts to fix some things in 1992, and we are going to work hard to pass an aggressive law that protects the little guy in this round.

And I thank you very much for your testimony this morning, and as we work our way through the process we will keep you informed by our final drafts. And I hope by the end of it, you will see that democracy, in fact, works.

Thank you.

And we will convene the next panel in 10 minutes.

[Recess.]

Chairman JOHNSON. The committee will reconvene. We are in the process of a recommit vote, and I think the other committee members probably decided we were not going to reconvene until after the recommit vote. At least I am guessing that that is what they concluded, since none of them are back.

So as much as I hate to proceed, I think if we do not we are going to run into all kinds of other problems with afternoon planes.

So, my understanding that because of the delay you are interested in foregoing your comments, because we do have your testimony and we really are interested in what you have to say.

But some of the things that have come up, you have heard the issues that we are raising, and I would like to see if you have further comments on those issues. I am particularly interested in your comments on the preceding panel and the difficulty of joint and several liability, but also on electronic filing, and the modernization program. You have some expertise that goes beyond the narrow purview of this committee.

So if you would each make some comments on the issues that have been raised this morning, and also on these other issues I would be interested.

Commissioner Goldberg, would you start, please?

STATEMENT OF FRED T. GOLDBERG, PARTNER, SKADDEN, ARPS, SLATE, MEAGHER, & FLOM (FORMER COMMISSIONER, INTERNAL REVENUE SERVICE)

Mr. GOLDBERG. Sure. Thank you very much, Madam Chairman. It is a pleasure to be here this morning. With respect to tax systems modernization, my belief is that that is the single most important step that can be taken to enhance the rights and safeguards for the taxpayers of this country.

I think the tax system imposes an intolerable burden and I believe that modernization is the necessary step, the necessary predicate to relieve that burden. I think the problems we are seeing in the filing season this year would be largely remedied if tax systems modernization were in place.

I think you would have a world where you could both address those few taxpayers who engage in fraudulent activity without unduly and unfairly burdening the vast majority of citizens who are attempting to pay their fair share.

With respect to attorney's fees, I think the provisions in 988, the Contract With America ought to be applied to tax cases. I believe the government should be held to that liability. In effect, a strict liability standard comparable to that in 988. I also believe that the scope of 7430 should be broadened substantially.

I do not criticize——

Chairman JOHNSON. What do you mean by that?

Mr. GOLDBERG. I think that the IRS has been criticized for the limited awarding of attorney's fees. I do not believe that that is an IRS problem. I believe it is a statutory problem. And 7430 is drafted, it is simply a lot less than meets the eye.

For example, I would make attorney's fees available to all taxpayers. I would shift the burden of proof to the government in cases where taxpayers prevail. I would relax the definition of substantially prevailed and I think that the underlying assumptions of 988 apply with even greater force to the Internal Revenue Service.

There are lots of other issues that have come up. It is inappropriate to monopolize the time, and I turn it over to my colleague.

The one other issue I do want to comment on very briefly is the shifting of burden of proof to the government in tax cases. I think

that that is the gap between good intentions and disastrous consequence in that legislation is as striking as any proposal under consideration.

If that proposal were enacted it would be the worst of all possible worlds. It would result in a substantial loss of revenue from those who are bound and determined to cheat. And I think it would lead to an IRS that would be terribly intrusive.

For all of the honest taxpayers out there I think it is a very well-intentioned idea, but it is the siren song.

Chairman JOHNSON. Could you comment, lastly though, on this issue of whether or not a spouse should be liable for——

Mr. GOLDBERG. Yes. I think the current law has problems but I think the lesson is beware of unintended consequences. That with the best intentions in addressing that issue, and I do encourage you to address that issue, if you have, for example, a situation where a spouse works to put his or her mate through college and graduate school and earns all of the income, and that mate is responsible for filing returns, doesn't file a return.

Then subsequently gets divorced and thanks to his or her education is making a great deal of money. And the other spouse who earned that earlier income is supporting the kids on $15,000 a year. Under the rule you were talking about, it would be that spouse who had educated his or her mate, who had cared for the children who would be stuck with the liability. I do not think that is fair.

So my only advice is to be careful as you address that issue to be sure you do not create other unintended inequities.

I think the case you heard this morning is extraordinarily sympathetic.

[The prepared statement follows:]

Statement of
Fred T. Goldberg, Jr.
Before the
Subcommittee on Oversight
House Committee on Ways and Means

March 24, 1995

Madam Chairman and Members of the Subcommittee:

I appreciate the opportunity to testify before you today on ways to enhance taxpayer rights and safeguards. Properly defined, this objective embodies the most important challenge facing tax administration. I applaud your interest, concern and ongoing oversight in this area.

While I am appearing today solely in my individual capacity, and not on behalf of any client or organization, I have had the privilege of addressing this issue from other perspectives: as IRS Chief Counsel, IRS Commissioner, and Assistant Secretary for Tax Policy. I also have perspectives on this issue as a private practitioner, taxpayer, and citizen. These different vantage points have shaped my views on how best to maintain and enhance taxpayer rights and safeguards. In particular, they have convinced me that all participants in the tax system -- the Federal government, Treasury and the IRS, taxpayers, tax practitioners and citizens -- share the same overriding objective of enhancing taxpayer rights and safeguards. Moreover, I am convinced that all parties can agree in large measure on the best avenues to achieve their common goal.

A. Preliminary Comments. Before turning to the specific questions you raised in the hearing announcement and in your invitation to appear before this Subcommittee, I would like to offer one general observation. So much of what we do in our public and private lives is about setting priorities and making choices. The same applies to the issue you are addressing today. The list of "things" that could be explored to enhance taxpayer rights and safeguards is truly endless. Any effort to consider (or do) them all would be futile and counterproductive. The challenge is to identify the "vital few" and assure that they are pursued vigorously and successfully.

In my opinion, there are two steps that must be taken to enhance taxpayer rights and safeguards. They both embody the same objectives as an item in the Contract With America: the "Job Creation and Wage Enhancement Act" provisions that focus on reducing the regulatory burden on our citizens. In the context of the tax system, the most important single step that can be taken is to achieve a dramatic reduction in the administrative and compliance burdens placed on taxpayers. The importance of this effort cannot be overstated: an intrusive, unresponsive and unworkable tax system is imposing an unacceptable burden on our citizens, and is a primary cause for the widespread distrust of government.

The two steps I recommend are:

1. *Tax Systems Modernization ("TSM").* Fully fund Tax Systems Modernization ("TSM") (including the funds requested in the Administration's Budget Request for FY 1996), and provide the constructive oversight necessary to assure its timely and successful implementation. The IRS is running on outmoded computers and stone age information systems. As a result, taxpayers waste hundreds of millions of hours and dollars each year in their dealings with the IRS. Issues that should never arise take months to resolve. Issues that should be resolved in a phone call require years of correspondence. Taxpayers must deal with numerous IRS employees to resolve the simplest of matters, when only one contact should suffice. A taxpayer needing a copy of his or her tax return to apply for a loan or a scholarship should be able to get a copy from the IRS in days; it now takes an average of several months, and millions of taxpayer requests for copies of their returns are never filled.

TSM can be and has been described in many ways. My own preference is for the framework embodied in the notions of burden reduction and "one stop service." Taxpayers ought to be able to resolve most IRS matters by dealing with one individual, most often through a single phone call. Based on my various experiences in government and the private sector, I am confident that TSM, properly designed and implemented, will save taxpayers hundreds of millions of dollars and hours each year. As a result, full funding of TSM, coupled with constructive oversight, is the single most important action that this Congress can take to enhance taxpayer rights and safeguards.

I recognize that TSM, standing alone, will not be sufficient. I should also emphasize that it will only succeed if the IRS is committed to a vision built around reducing the burden on taxpayers. Finally, I acknowledge that many mistakes are certain to occur along the way in an endeavor of this magnitude. Having said as much, the fact remains that TSM is the one essential step that must be taken. If that effort is delayed, or is not successful, there is nothing that this Subcommittee or any one else can do to rescue our citizens from an intrusive, burdensome and overreaching system of tax administration.[1]

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[1] As I've indicated, the IRS has made mistakes in pursuing TSM, and will make more mistakes as it goes down the road. That's reality, and to be expected. All in all, the IRS is doing a fabulous job. While it should be encouraged and supported in its efforts to do better, there is no turning back. If anything, the pace should be accelerated.

In this regard, I should acknowledge recent GAO criticism of the IRS modernization effort. In my opinion, the GAO commentary is simply wrong. It displays a stunning lack of perspective. It ignores reality and is often misleading. I believe it can be fairly characterized as destructive and counterproductive. I realize that these are harsh words. Unfortunately, I believe

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2. *Tax Simplification*. Pursue tax simplification -- relentlessly and creatively. We are crushing our citizens, as well as our business, charitable and religious institutions with laws, regulations and procedures that are burdensome, duplicative, frequently unworkable, and often counterproductive. Simplification is another essential step that must be taken to enhance taxpayer rights and safeguards.

I acknowledge the common wisdom: when Congress threatens to simplify the tax law, most taxpayers and practitioners decide it's time to duck. That pattern must change. While fundamental reform may be the only way to achieve the kind of dramatic simplification that is called for, major steps can be taken within the confines of the current system. In particular, "think outside the box" -- recognize that any tax system is a grotesque necessity, not an end in itself; abandon the pathological quest for theoretical purity. Skip cosmetic surgery; excise whole tumors. When given the choice, simplify in a way that "loses" a little revenue -- increased receipts from improved compliance and reduced administrative costs will far off-set the "estimated" loss. Don't bother trying to simplify in a way that "raises" revenue -- it simply replaces one form of tax with another; it's just not worth the effort. Beware of "loophole closers": for the most part, they amount to surgery on the capillaries of a patient that's expiring from ruptured arteries. If truth be told, the revenue that most "loophole closers" generate goes to line the pockets of lawyers, accountants, investment bankers and other intermediaries.

B. Comments on Specific Proposals. Various measures previously considered by Congress (*e.g.*, H.R. 3838, as proposed and as modified for inclusion in H.R. 11), and measures introduced in recent months (*e.g.*, H.R. 390, H.R. 661, and S. 258), contain numerous proposals that are intended to enhance taxpayer rights and safeguards. I will limit my comments to the following broad areas: (1) the burden of proof; (2) attorneys' fees; and (3) a suggested framework for considering myriad specific provisions.

1. *Suggested Changes in Rules Governing the Burden of Proof*. From time to time, and for many years, it has been suggested that the IRS should bear the burden of proof in tax litigation. Boiled down to its essence, the appeal of this Siren song is obvious: in a democracy, it's simply wrong to put the burden of proof on a citizen in his or her dealings with the government. Framed this way, I'm certainly tempted to agree.

Unfortunately, I am convinced that shifting the burden of proof in tax cases would be the surest and most direct route to the worst of all possible worlds. It would be an enormous windfall to the few taxpayers who

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[1](...continued)
they are accurate. I recommend that this Subcommittee, and other affected Congressional committees, consider restructuring or terminating GAO's responsibility in this arena and pursue other oversight avenues that will help assure that TSM is carried out successfully.

are bound and determined to cheat the system; it would impose an intolerable burden on the vast majority of honest taxpayers who do their best to comply with the law.

For better *and for* worse, our system relies on self-assessment by taxpayers. The system functions because taxpayers are expected to maintain adequate records and to report properly their items of income, deduction, credits and the like. Changing the burden of proof would have two consequences:

First, it would reduce voluntary compliance. While most citizens would continue to try to pay their fair share, there would be some who would take advantage of the new framework to understate their liability and leave it to the government to prove a different result. While I am convinced that most taxpayers are fundamentally honest, and that the decline in voluntary compliance would be small in percentage terms, the revenue loss and the gradual erosion in the perceived fairness of our system would be sizeable. To put this in perspective, a decline of only 1% in voluntary compliance would cause an annual revenue loss of more than $10 billion. While estimates of this sort are highly speculative, my personal view is that the annual revenue loss ultimately would exceed this amount.

Second, largely in response to the foregoing, the IRS would be compelled to alter its approach to enforcement. Most of us believe that the IRS is far too intrusive today, and that tax administration is far too cumbersome, contentious and burdensome. Well, as the saying goes, "you ain't seen nothin' yet." Change the burden of proof and IRS tactics of today will seem like child's play. ***Of necessity***, the IRS would be forced to resort to far more aggressive techniques in auditing taxpayers and developing cases. Summonses, including third party summonses, would become routine. Expanded record-keeping requirements and increased litigation over discovery issues would be standard fare. In addition, the number of revenue agents and audits of taxpayers would likely increase dramatically. In the world of tax administration, it's hard to imagine a more well-intentioned idea that would have more undesirable consequences.

Having said as much, I do believe there are several areas where the burden of proof question could be addressed by Congress. The first involves a clarification included in H.R. 11 in response to the Tax Court's decision in Portillo v. Commissioner, 58 TCM 1386 (1990), *rev'd in part and aff'd in part*, 982 F.2d 1128 (1991). Section 5503 of H.R. 11 would have required the IRS to provide additional probative evidence in addition to the copy of an information return in litigation regarding the inclusion of additional income reflected on that return. Because taxpayers are faced with the need to "prove a negative" in unreported income cases involving information returns, I believe a change along these lines is warranted. At the same time, however, I should note that this provision reflects current IRS administrative practice and is therefore likely to have little practical impact except in rare and unusual circumstances.

A second area where the burden of proof should be shifted involves attorneys' fees. As noted below, I believe that the award of attorneys' fees to taxpayers should be automatic in certain circumstances. Under the current regime, Section 7430 requires a taxpayer who has substantially prevailed to prove that the government's position was "not substantially justified." Once the government has lost, I think it appropriate to require the government to prove that it's position was substantially justified.

2. *Attorneys' Fees.* As a citizen, and as an attorney, I believe that provisions contained in the Contract With America's "Common Sense Legal Reforms Act" are long overdue. I congratulate you and your colleagues for your timely action. My one observation is that the original proposals have already been diluted needlessly in some respects; hopefully, they will sail through the Senate during the coming months without taking on any more water.

The rationale underlying H.R. 988 is even more compelling in tax cases. I am confident that the government does not engage in "strike suits" for the purpose of extracting settlements from taxpayers. On the other hand, the practical effect can be the same. Moreover, the government lacks the same kind of settlement incentives that are present in the private sector because there are no market pressures requiring a rational allocation of resources. Finally, the government occasionally insists on litigating a case to "make" or "clarify" the law without regard to its risk of losing. While such action may be appropriate, there is no reason why a prevailing taxpayer should be required to foot the bill. Accordingly, I recommend that costs and expenses should be imposed on the government under circumstances similar to those identified in H.R. 988 (tailored to meet various procedural considerations unique to tax controversies).

I recognize that consistency would impose a corresponding liability on taxpayers. While that approach might be warranted, I urge the Subcommittee to address that question in light of the other sanctions imposed on taxpayers under current law (*e.g.*, the Section 6662(b)(2) substantial understatement penalty, the Section 6662(b)(3) and (b)(5) valuation misstatement penalties, the Section 6662(b)(4) pension liabilities overstatement penalty, the Section 6621(a)(2)(B) excess interest charge on taxpayers, the Section 6621(c) penalty interest provision applicable to large corporations, and the Section 6673 sanctions where a taxpayer's litigating position is "frivolous").[2] Stated differently, if a parallel regime governing attorneys' fees is desired,

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[2] My personal view, unsupported by any particular logic, is that taxpayers should be permitted to spend their time and money litigating against the government in tax matters despite the odds -- without liability for attorneys' fees. While I recognize that this has the practical effect of imposing costs on all other taxpayers, there is something quintessentially American about challenging the government "just to make a point" (perhaps, about the unintended consequences of the law or the absurdity of the government's own rules).

these other sanctions should be revisited and modified. Under no circumstances, however, would I make taxpayers involved in small case litigation (so-called "S" Cases) subject to liability for attorneys fees.

I also recommend that the provisions of Section 7430 be broadened and relaxed in several respects (*e.g.*, as noted above, shift the burden of proof to the government; make the award of attorneys' fees under Section 7430 available to all taxpayers; delete the limitations contained in subparagraphs (b)(1), (b)(3) and (b)(4); relax the "substantially prevailed" standard). The IRS has done a reasonable job of administering Section 7430 as drafted. The problem is that the statute, as drafted, is too narrow.

Finally, while it does not relate directly to the awarding of attorneys' fees, I would like to comment on costs incurred by taxpayers arising out of the so-called Taxpayer Compliance Measurement Program (TCMP). While such examinations are wholly appropriate in that they seek to determine the taxpayer's proper tax liability, they also purport to serve other objectives relating to tax administration.[3] The ordeal that taxpayers must endure to survive a TCMP audit defies description. If this program is continued, I believe that taxpayers should be entitled to recover reasonable costs incurred in the process.[4]

3. *Framework for Considering Other Proposals.* I suggest that the Contract With America, and Phil Howard's recent book, The Death of Common Sense: How Law is Suffocating America (1994) serve as a starting point for considering myriad other proposals to enhance taxpayer rights and safeguards. I also recommend Bayless Manning's remarkably prescient article, "Hyperlexis: Our National Disease," 71 Northwestern University Law Review 767 (1977), as well as Gordon Henderson's "Controlling Hyperlexis--The Most Important 'Law And . . . . .'," 43 Tax Lawyer 177 (Fall 1989).

The Contract, Mr. Howard's book, and the articles by Mssrs. Manning and Henderson make a simple and compelling case. We can't legislate common sense or good judgement. We cannot enact laws to right every wrong. While such efforts may be well-intentioned, they do more harm than good.

The same applies to tax administration and to legislation designed to enhance taxpayer rights and safeguards. Legislation that is intended to mandate common sense, or to right every wrong, is sure to fail. There are simply too many areas where common sense is required, and where its application to specific circumstances cannot be adequately anticipated. Likewise, there are too many "wrongs" that cannot be "righted" by legisla-

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[3] As noted above, this same concept provides an additional rationale for requiring the government to pay attorneys' fees.

[4] In the spirit of full disclosure, I should acknowledge my oft-stated view that TCMP has outlived its usefulness and should be restructured or abandoned.

tion. The law of unintended consequences has far too wide a reach.

The best of legislative intentions often pave the road to more litigation, greater taxpayer burdens, increased uncertainty, and counterproductive side effects. In all too many cases, legislation of this type is a futile effort to treat symptoms, while ignoring causes. If Congress concludes that there are areas where the Service consistently displays a lack of common sense, the better approach is to use the oversight process.

The primary focus of legislation -- *and administrative actions* -- should be to ***remove barriers*** to the exercise of common sense. I am convinced that taxpayers' rights are violated most often in cases where "the rules" prevent (or are perceived as preventing) fair play and the exercise of good judgement.

Finally, I would like to return briefly to the point I made at the outset regarding choices and priorities, and reference the Contract With America's attack on unfunded mandates. Every measure you enact entails a choice, and sets a priority. Every measure you enact imposes a "mandate" on the IRS. If you require the IRS to take any action, it means the IRS will not do something else, or will do something else less well.

With these observations in mind, I have the following comments on various proposals that may be considered by this Subcommittee as it deliberates in the months ahead. They are not intended as an exhaustive list; rather they are intended to illustrate the difference between attempting to legislate common sense and empowering the exercise of good judgement. Because I am more familiar with H.R. 11 as approved by Congress in 1992, my references are to provisions of that bill. By and large, my comments are equally applicable to taxpayer rights legislation introduced since that time.

Proposal	Comments
Restructure the Ombudsman position, and limit authority of senior officials	This is an effort to legislate common sense by imposing rigid lines of authority and reporting chains. It would accomplish little good, could cause much harm, and would be a barrier to the exercise of good judgement.
Installment Agreement Changes: automatic right, mandatory 30-day notice, mandatory "independent administrative review"	Once again, an effort to legislate common sense by imposing rigid rules. Proposals would accomplish little good, would cause much harm (including a substantial increase in noncompliance and lost revenue), would impose needless administrative costs and prompt needless litigation, and would be a barrier to the exercise of common sense. The IRS is doing a far better job in administering Offers in Compromise and Installment Agreements (thanks in large measure to the work of this Subcommittee). The primary challenges are to achieve greater consistency (there are still pockets of resistance to change) and to continue refining standards (not every taxpayer can be expected to win the lottery or inherit a million dollars). Legislation is not the way to assure progress on these fronts. On the other hand, it is clearly appropriate to suspend the failure to pay penalty during pendency of an installment agreement.
Preclude the issuance of retroactive regulations	In very rare and unusual circumstances, retroactive regulations may be justified. While Congress may wish to legislate guidelines limiting their use, I believe that the government has generally (though not always) exercised its retroactive authority with proper care. A more effective avenue may be ongoing oversight to assure that Treasury and IRS use good judgement. It is also worth noting a related problem: the rush to judgement. While I would not recommend a legislative solution at this time, I am concerned that a preoccupation with "protecting the revenue" leads to IRS rules and regulations with immediate effective dates that are not well thought out from a policy or implementation perspective. While nominally prospective, these pronouncements can be every bit as pernicious as facially retroactive rules.

Interest abatement	I am of two minds on this issue. The arguments against abatement authority are: interest is simply a charge for the use of money; it is a mechanical computation and abatement is inappropriate. Moreover, abatement authority would spawn substantial new litigation over standards that would be extremely difficult to apply in practice. The argument in favor of abatement focuses on IRS-caused delays, and the additional cost that those delays impose on taxpayers. I think this debate misses several points. First, many taxpayers do not see themselves as "borrowers" -- as the result of an honest mistake, a financially strapped family is faced not only with an unanticipated tax bill, but an enormous interest charge as well. Second, the tax law imposes numerous "finance" charges in addition to interest (*e.g.*, failure to file and failure to pay penalties). Third, deficiency interest rates do not reflect the government's cost of funds; they purport to reflect taxpayer borrowing costs. On balance, I think that the interest abatement proposals under consideration will accomplish less than hoped (*c.f.*, attorneys' fees under Section 7430), and will cause far more administrative difficulties than imagined. As a first step, I think that the better approach would be to do a better job of clarifying objectives, and explore various mechanical changes (*e.g.*, lower rates under certain circumstances) to achieve those ends. If it's not possible to make the mechanics work properly in that context, I would recommend abatement authority that is broader than currently proposed: permit the IRS to take all factors into account (*e.g.*, hardship, nature of the adjustment, taxpayer's prior compliance history, role of outside advisors, etc.). It may also be appropriate to limit the abatement authority to amounts above the government's cost of funds.

Following are other examples of provisions that give taxpayers or the IRS more latitude to exercise common sense:

- Sections 5301 and 5302 of H.R. 11 (relating to joint returns) -- provides taxpayers with greater latitude to exercise common sense
- Sections 5401 and 5402 of H.R. 11 (modifications to lien and levy and offer-in-compromise provisions) -- provide the IRS with greater authority to exercise common sense

Following are examples of provisions that I believe are futile or counterproductive efforts to legislate common sense:

- Sections 5604(a) and (c) of H.R. 11 (relating to the Section 6672 penalty for failure to collect and pay over tax) -- the goals and the approach are both laudable, but the mechanical rules are likely to create more problems than they solve

- Section 5801 of HR. 11 (required content of certain notices) -- notice clarity, like beauty, is in the eyes of the beholder; more to the point, neither can be legislated. (And, moving from the sublime to the ridiculous, the legislative history provides that IRS failure to comply with the statute has no consequences.)

- See, also, Sections 5901 and 5902 if H.R. 11.

C. Conclusion. Perhaps the best way to summarize my views is to urge you to heed the teachings of the Contract With America: set priorities -- don't try to enact laws to solve all the ills that afflict tax administration; focus on reducing the burden that the tax laws and tax administration place on taxpayers and citizens; don't try to legislate common sense -- empower the exercise of good judgement; be sensitive to unfunded mandates, even on the IRS.

Chairman JOHNSON. Thank you.
Mr. Gibbs.

STATEMENT OF LAWRENCE B. GIBBS, PARTNER, MILLER & CHEVALIER (FORMER COMMISSIONER, INTERNAL REVENUE SERVICE)

Mr. GIBBS. As usual, I find myself in agreement, Madam Chairman, with another former commissioner. So I will not repeat what Fred said. I will simply comment on another area that was discussed this morning, and that is the issue about the ombudsmen or the taxpayer advocate.

Frankly this is one where my prior public statements have been sympathetic toward the IRS. I think I understand what you are trying to do, and I would like to make what I hope might be a constructive suggestion.

Chairman JOHNSON. Go ahead.

Mr. GIBBS. I think the biggest concern that I have, and I heard it somewhat this morning, is the attempt to legislate good sense or common sense for these kinds of rules. The problem this creates, when you think you are legislating good sense, is that it gets you into some of the issues that deal with the organization and management of the IRS, and it tends to take on a micromanagement flavor.

On the other hand, with respect to some of the questions you have asked today, the things you have gotten into, the issues with respect to the ombudsmen reports, and similar types of things, I am wondering whether you could not accomplish the same thing by letting the American public know that this is going to be an issue, and asking the IRS and Treasury to give you a report by a certain date on each of the items.

And hold hearings and have an ongoing type of dialog to see why you cannot get the information you want. If there are management concerns with what you are suggesting, in terms of line authority of the ombudsmen or the taxpayer advocate over all of the IRS field organization, get into that to explore it.

But I would urge that in the context of the changes you propose, and in light of everything else that is happening at IRS, you should do that on more of an oversight type of basis, rather than trying to simply legislate the answers.

[The prepared statement follows:]

TESTIMONY OF LAWRENCE B. GIBBS

BEFORE THE SUBCOMMITTEE ON OVERSIGHT

COMMITTEE ON WAYS AND MEANS

U.S. HOUSE OF REPRESENTATIVES

REGARDING EXPLORATION OF THE DEVELOPMENT OF

TAXPAYER BILL OF RIGHTS II LEGISLATION

MARCH 24, 1995

Madam Chairwoman, I am pleased to be here today to testify regarding the Subcommittee's exploration of the development of Taxpayer Bill of Rights II legislation. I was the Commissioner of Internal Revenue at the time the original Taxpayer Bill of Rights was passed in 1988. Although I did not initially support all of the provisions in the 1988 legislation, when it became clear that the Congress intended to pass the legislation, I worked with members of the tax writing committees in Congress and their staffs in the development of the 1988 legislation, and I oversaw the initial activities by the IRS to carry out the provisions after enactment. After leaving the IRS in 1989, I have continued to take an interest in the subsequent Taxpayer Bill of Rights proposals including correspondence with members of Congress and discussions with their staffs about various provisions in those proposals. Some of my comments today have been adapted from, and therefore are similar to, my prior communications.

During my tenure as Commissioner I worked with your predecessor in attempting to assure that the IRS met its obligations to fully and fairly collect the proper amount of tax owed to the Federal government. In addition, I have represented taxpayers in dealing with the IRS before and after serving as Commissioner. I therefore recognize, as I know you do, the difficulties that the IRS faces in collecting the amount of tax properly owed and at the same time doing so in a fair, even-handed and professional manner.

I take seriously the importance of balancing the authority needed by the IRS to discharge its obligations with the rights of individual taxpayers in their dealings with the IRS. You well know, and I recognize, that the balancing of such authority needed by the IRS with the rights of individual taxpayers is often as difficult as it is important. This is particularly true at the present time in light of the government's need for revenue, the complexity of our Federal tax laws, and the increasing lack of confidence and respect of our citizenry in governmental authority.

In view of these competing considerations, I have considered carefully many of the provisions in the subsequent Taxpayer Bill of Rights proposals. Some of the provisions may be helpful, but I have substantial concerns about the impact of other provisions on our Federal tax system. There are three provisions that I feel so strongly about for the reasons indicated below that I urge you not to include them in any legislation that you may subsequently consider.

1. **Shifting the Burden of Proof.** H.R. 390 would change the law to provide that in any Federal tax proceeding the burden of proof with respect to all issues would be upon the IRS. As indicated in the excellent summary prepared by the Staff of the Joint Committee on Taxation for this hearing, under present law the taxpayer generally has the burden of proof in all civil Federal tax proceedings. Therefore, the change proposed by H.R. 390, if

enacted, would shift the burden of proof from the taxpayer to the government. I oppose this change because I believe it is misguided, is likely to result in increased noncompliance with our tax laws, and is likely to mislead innocent taxpayers.

The policy behind this change is misguided because, I believe, there is a failure to understand how our Federal income tax system operates. In many countries, the tax collector initially decides how much tax to assess against a taxpayer, and then the taxpayer has the burden of proving that the tax collector is wrong. In the United States, taxpayers initially decide how much tax to pay and assess themselves by filing their Federal income tax returns. On the basis of taxpayers' self-assessments, the IRS each year pays refunds that average about $1,000 each to approximately 85 million taxpayers, for a total annual cost to the government of around $85 billion.

This is particularly significant when one considers that for most taxpayers the chances are less than 100 to 1 that the taxpayer's return will be audited. Further, if a taxpayer is audited, it also is significant that the taxpayer, and not the IRS, generally has all of the records and personal knowledge of the facts surrounding the transactions and activities reflected in the tax return. In light of all this, our present system is predicated on the assumption that because a taxpayer initially prepared and filed the return based on the taxpayer's information and knowledge (and often received a substantial refund based on the return as filed), it is fair to ask the taxpayer to bear the burden of proving that the return is correct if the IRS subsequently disagrees.

In short, under our present system, the taxpayer is presumed to have correctly prepared and filed the return, and for 85 million taxpayers--almost 75 percent of all taxpayers--the IRS relies on this assumption to pay substantial refunds without any questions asked. For these reasons, it is totally inappropriate to suggest, as some have stated, that a taxpayer is "presumed guilty" until "proven innocent" under the present system.

If the Congress passes the proposal in H.R. 390, I believe that some taxpayers may be led to understate their tax and overstate their refunds. Last Wednesday's Wall Street Journal discussed a recent survey which suggests that five percent of our taxpayers cheat on their taxes, and twelve percent would do so if they thought they would not be caught. Similar studies suggest that, apart from cheating, many taxpayers are more inclined to take aggressive positions on their tax returns if they believe that they are less likely to ultimately have to pay any additional tax. If Congress passes legislation shifting the burden of proof and taxpayers become less compliant because of their belief that the IRS will not be able to prove the lack of compliance, not only will our government's tax revenues decrease but also in such event the tax burden on compliant taxpayers will increase.

Finally, taxpayers who subsequently litigate with the IRS and do not properly prepare their cases under the mistaken belief that the shift in the burden of proof means that IRS must "prove everything" may be surprised and upset when they are confronted with discovery demands by the IRS and ultimately by an adverse decision by the court. All of us who have been involved in litigation understand that in today's climate of substantial discovery, it is likely to be difficult for a taxpayer to use burden of proof as a substantial sword or shield. Taxpayers representing themselves before the IRS and the courts, however, may be misled into believing that they do not have to produce information and arguments justifying the amount of their income and deductions if the government is required to bear the burden of proof. For these taxpayers, any new legislation shifting the burden of proof ultimately may be seen as a cruel hoax.

Because of the inherent fairness of our present system, the risk of potentially substantial losses of revenue if the burden of proof is shifted, and the confusion and uncertainty of pro se taxpayers about the implications of the shift, I oppose and would urge you to reject this legislative proposal.

2. Retroactivity of Treasury Regulations. Presently, Treasury and IRS officials have discretion about the extent to which regulations can be promulgated retroactively. Under Section 5803 of H.R. 11, proposed and temporary regulations could not be applied retroactively to periods preceding the date of publication unless Congress so provided or unless necessary to "prevent abuse of the statute to which the regulation relates" or "correct a procedural defect in the issuance of any prior regulation."

As a former Commissioner and as a practitioner, I support the notion that regulations should be issued promptly after legislation is enacted in order to provide affected parties with appropriate guidance and also to avoid the problems that retroactivity creates. However, because of the volume and complexity of tax legislation so frequently passed by Congress over the last thirty years, in my experience it has been increasingly difficult (maybe impossible) for the Treasury Department and the IRS to issue regulations as promptly as desirable and needed. Further, it is my experience that, under our government of checks and balances, it often is easier for taxpayers and their representatives to block or defer the issuance of regulations than it is for the Treasury and IRS to issue them timely, particularly those regulations that are perceived to affect the interests of taxpayers adversely.

Tax policymakers and administrators must deal with the delicate and difficult decision as to whether and to what extent a regulation should be retroactive or prospective. They must deal with a variety of different situations in which retroactivity, rather than prospectivity, is called for or required. I do not believe that the exceptions in the proposal to permit retroactivity are sufficient to cover the myriad of situations and conditions in which the issues arise. Indeed, in light of these circumstances, I seriously doubt the wisdom of attempting to prescribe in advance when regulations should be promulgated retroactively or prospectively. I believe that flexibility to respond to the exigencies of the particular situation is critically important, and that such flexibility is fundamentally what is included in the present provisions of Section 7805(b) of the Internal Revenue Code.

In balancing the needs of the IRS with the rights of taxpayers, I believe that the present flexibility should be continued. Courts have fashioned numerous remedies to permit taxpayers to overturn or circumvent regulations in appropriate circumstances. Over the last thirty years the courts consistently have demonstrated a willingness to uphold taxpayers' actions despite contrary provisions of the regulations when a court determines that the taxpayer has substantially complied with his or her tax obligations or that the IRS has abused its discretion in formulating or administering its regulations. Therefore, I urge you to reject this proposal.

3. Political Appointment of Ombudsman. Presently, there is a Taxpayer Ombudsman on the staff of the Commissioner of Internal Revenue who is appointed by the Commissioner and who oversees the Problem Resolution Program (PRP) of the IRS. Section 5001 of H.R. 11 would replace the Ombudsman with a "Taxpayer Advocate" who would be appointed by the President and confirmed by the Senate and who would supervise all of the PRP personnel. As a former Commissioner and a practitioner, I have worked directly with the Ombudsman and PRP representatives, and I enthusiastically support their goals and activities. My experience suggests that the role and importance of the Ombudsman and the PRP programs are increasing. I believe that among the keys to continued

effectiveness of these programs is the need to institutionalize the attitudes and objectives of the Ombudsman and PRP throughout the policies, procedures and personnel of all of the functions of the IRS.

In my opinion, the proposal in H.R. 11 would do just the opposite. By creating a new office headed by an independent Presidential Appointee and given a statutorily mandated independent function, the proposal separates PRP. In any large organization, once a program is separated, it becomes almost impossible to institutionalize the attitudes and objectives of the program. If the present proposal is enacted to statutorily mandate the Presidential appointment of a Taxpayer Advocate to whom the PRP program will be responsible, I believe that the detriments resulting from such change will more than offset any intended benefits.

Further, I am concerned that the rigidity and difficulty of amending statutory provisions will stifle the activities of the Ombudsman and PRP. At a time when the business, organization, and activities of the IRS are undergoing substantial and continuing change, I believe that the Ombudsman and PRP must have the flexibility to make changes in organization, activities and functions that will not be permitted by the proposed statutory provisions in H.R. 11. In light of the difficulty that Congress has had in passing technical corrections bills in recent years, I do not believe that there is sufficient flexibility in the Congressional tax legislative process to be able to accommodate the need for changes in the statutory provisions that future events affecting IRS in general, and the Ombudsman and PRP in particular, may require.

I am particularly concerned that the changes proposed may politicize the Ombudsman and thereby render the Ombudsman less effective in leading and managing PRP. As you may know, the Ombudsman presently is involved personally on a daily basis in numerous audit, collection and other enforcement activities affecting specific taxpayers. Often taxpayers or their representatives request the involvement of the Ombudsman. History has taught all of us about the dangers inherent in the involvement of political appointees in such activities on a day-to-day basis at the request of taxpayers. I therefore oppose and urge you to reject this proposal.

Thank you for inviting me to testify. I will be happy to answer any questions.

Chairman JOHNSON. That is a very interesting comment. It is particularly interesting because the one thing the Congress has been really outstandingly bad at is oversight.

And then we come in with either extraordinary penalties or micro-managing the administrative structure and then we wonder why government costs more, and it is more burdensome and more tangled. But that is a thought that I will take to heart and think through.

Mr. GIBBS. Ms. Johnson, this is my second time to attend one of your hearings. I worked closely with your predecessor, and I must tell you that in terms of the quality of the hearing that was the last hearing you had with the IRS and the quality of the hearing today, you ask good, hard, tough questions. So do the other members. That is the tradition here. And I would simply tell you that I think that with the quality of the staffs that you have, and under your leadership, I think something like that could really work with the IRS.

Chairman JOHNSON. Thank you.

I do think that the Congress, as the rest of the world—but certainly government policymaking is entering a new era. I think when you have to make change in the way this society has had to make change, when you look at the change in authority from the CEO, the guy at the machine in the factory and that is true in every other sector.

But we are going to have to make that power shift in government, too. We are going to have to make the power shift from the central power to the people on the line who are dealing with the constituents. But if we are going to have any quality, we are going to have to figure out how to oversee that and in the public sector we have never been very good at that.

One of the issues that the preceding panel brought up was the catastrophic level of victimization of some people in the current system.

And all of our regulatory reform is coming from bureaucrats in EPA who will not be rational. I mean I have dealt with them and they are in every agency. And it is unfortunate because there are lots and lots and lots of folks in all those agencies who are doing a wonderful job and are thinking through the implications of the law and the circumstances of a particular case.

And it is, in a sense, the irrational one or the hard-nosed one, the one who does not give a damn anymore that gives the bureaucracy a bad name and sometimes results in the wrong kind of legal change.

So if we can do a better job of oversight and we are going to try it very soon, so that we can see what is that tangle down there that needs to be released and can it be released through that current structure.

But I thank you. I am very proud of this committee. We have been preoccupied with other things, but I think we have never had a stronger oversight committee in terms of the quality of the members and the breadth of their knowledge.

And I am looking forward to doing a far better job of oversight not only for members' knowledge, but for the public's knowledge. I appreciate your comment, thank you.

Mr. GIBBS. I think your comments, and those of the other members as well, about the ombudsman program are correct. My instinct is that it is working. What you are trying to do is to make it work better, and I understand that.

One comment to you though is that, as the Congress is beginning to look at putting things back to the local level and to the States, I am concerned because this proposal, in effect, attempts to address the problems by bringing more power and centralization into the taxpayer advocate here in Washington, D.C.

Chairman JOHNSON. Right, exactly, I understand that. I hear your comment and it is well taken.

Mr. GIBBS. Another thing that I would comment about: I thought Mr. Monks this morning said something that is very significant in the IRS culture and organization when he said, "let me sit on the selecting committees and let me review folks and their pay and promotion."

If you start building the advocate or ombudsman into pay and promotion, then there is a way of doing the matrix management. I think that will work and pick up the same benefits you see of having him involved in the field.

Chairman JOHNSON. I thought that was a very good comment. I thought the other point of his testimony that we actually did not pursue in questioning, but that was very significant is the issue of relationships within the office. How do you deal with this difficult problem and are you going to make people adversaries out there on the front line?

And how are you going to lead them as a team cooperating on tough problems that clearly are not ones that we are all proud of.

Mr. GIBBS. Yes, Madam.

Chairman JOHNSON. Mr. Alexander.

STATEMENT OF DONALD C. ALEXANDER, PARTNER, AKIN, GUMP, STRAUSS, HAUER, & FELD, L.L.P. (FORMER COMMISSIONER, INTERNAL REVENUE SERVICE)

Mr. ALEXANDER. In view of the passage of time and in view of the fact that I agree almost completely with——

Chairman JOHNSON. We are all right. You do not have to rush. We have time.

Mr. ALEXANDER. I agree completely with almost all of what Commissioner Goldberg said, and I agree with what Commissioner Gibbs said about oversight.

When I was commissioner during those tranquil days of Watergate we badly needed oversight. We needed it in the Ways and Means Committee, the best committee to give it to us. And we did not get enough of it.

I was delighted with the hearing this morning, Madam Chairman. I am delighted to hear you say that you intend to followup and have further and searching oversight hearings like this one.

IRS badly needs to have an updated computer system. I agree with what Fred Goldberg said and I agree with what he said about, please do not pass any measure which would shift the burden of proof on all issues, in all tax cases, to the IRS.

The system can stand much, but it cannot stand that.

[The prepared statement follows:]

TESTIMONY OF DONALD C. ALEXANDER
BEFORE THE
SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES
MARCH 24, 1995

INTRODUCTION

Our system of income and employment taxes imposed on a very wide base of individuals and corporations depends not only upon withholding, information reporting and reasonable but effective enforcement by the Internal Revenue Service but also upon the public's willingness to comply. The last factor does not lend itself readily to analysis, but I think that significant to the public's willingness to comply is a basic belief that the tax system is reasonably fair and is soundly administered. Unfortunately, the mind-boggling complexity of current law, much enacted largely in an effort to seek exact statutory fairness, threatens acceptance of the system and, therefore, compliance with it.

Another important element, as I see it, is how the public views tax administration. Now, no one likes to pay taxes, and no tax collector is likely to win a popularity contest. (I am continually surprised about how two former tax collectors in North Dakota were elected to the Senate.) But the job of the Internal Revenue Service is to try to make sure that all taxpayers pay the taxes due from them. This means filing all required returns, accurately reporting income and determining tax, and paying the tax due. Now there is bound to be some slippage in a system like ours, and there certainly is. If IRS' estimates of the tax gap (roughly the excess of what is actually due from legal-sector taxpayers over what is paid) are reasonably accurate, and I think they are probably low, then our budget would be almost in balance if we could close the tax gap completely and collect a reasonable part of what the illegal sector owes. Of course, this won't happen. But we need to narrow the tax gap if we can, and surely we shouldn't permit it to widen. Not only would widening the gap increase the deficit but it would also send the wrong signal to our many compliant taxpayers: Why should they pay if their neighbors don't?

The IRS is a large organization, as it must be. It should be larger. It badly needs a new computer system but in the meantime it does the best it can with the aging, inadequate system that it has. It has the vast responsibility of trying to make the system work and, like other human organizations, it is not perfect. Some of its many people at times come on too strong with taxpayers, at times are arbitrary, at times are forgetful, and at times are too lenient. I have great respect for the present Commissioner and she is doing an excellent job in trying to reconcile IRS' duty to assist taxpayers and be reasonable toward them and IRS' duty to cope with tax avoidance and evasion and collect overdue and unpaid taxes. By the way, I think it ironic that while IRS is being beat around the head and shoulders (not without some reason) for being overzealous in collecting revenues, the job of collecting child support payments is being pushed on the IRS. If IRS does such a bad job in collecting taxes, why give it an additional nontax task?

H.R. 390

This measure, proposed by Mr. Traficant, would place the burden of proof on the Internal Revenue Service on all issues in all tax cases. In my judgment, this is unwarranted and ill-advised. Within a short time it would do great damage to our broad-based income tax system. Without large increases in staffing--which I don't believe will occur--the Internal Revenue Service would be overwhelmed in its efforts to require compliance with the tax laws. Taxpayers (and there are some) who don't want to meet their obligations to their country and to their fellow

citizens would soon overlook income and make exaggerated claims to deductions and credits on their returns. The Internal Revenue Service, called on to prove in all matters and all cases that the taxpayer's reporting was wrong, would simply be unable to satisfy this burden. How can the IRS prove a negative without demanding and reviewing all records relating to a taxpayer? It would be unrealistic to believe that the many honest taxpayers who attempt to meet their tax burdens in full would not soon realize that others were beating the system and getting away with it. The tax gap would increase substantially, and compliance with the system would have a commensurate decrease. The deficit would correspondingly increase.

If Congress perceives that current law is not sufficient to rein in overzealous IRS agents, the way to meet the problem is to review and strengthen section 7430 of the Code, which calls for the United States to pay taxpayer's costs in defending against IRS actions which were not substantially justified. One must remember that IRS agents are "real people" too; they don't leave the human race when they sign on with IRS.

TAXPAYER BILL OF RIGHTS

The following represents my preliminary comments on Taxpayer Bill of Rights 2 (T2) as contained in H.R. 661 and S. 258.

My general comment about T2 is that, as a general rule, it is inadvisable to try to micromanage the Internal Revenue Service through legislation. Although the exercise of oversight responsibilities does consume valuable Congressional time, and I realize how little time Members actually have, I recommend that there be more oversight on how the Internal Revenue Service fulfills its vast responsibilities and less direction in the statute on exactly what the Internal Revenue Service must do and must not do.

1. *Taxpayer Advocate.* Let's give the current Ombudsman provision a chance to work. I think it is working reasonably well, but this can be tested, and should be tested, at Oversight hearings. A statutory taxpayer advocate of the kind envisioned would, I think, create as many problems as it would solve. In trying to balance rights of taxpayers against effective and economical administration of the tax laws, I think this drastic step is not needed at this time.

2. *Installment Agreements.*

A. Installment agreements should be fostered, not discouraged, and I believe the recent step in imposing a $43 charge for installment agreements was ill-advised and should be rescinded. If for some reason any charge of this kind must be made, it should be limited to amounts of unpaid taxes exceeding, at least, $50,000. I do not think that the authority to issue taxpayer assistance orders under IRC § 7811 should be extended to eliminate the current limitation to a "significant" hardship. In a broad sense, all Internal Revenue actions which seek to separate a taxpayer from money create "hardships", for all of us are better off with our money than without it. Surely this should not be the sole test.

B. T2 would provide an automatic right on the part of an individual taxpayer to cause the Service to enter into an installment agreement if the unpaid tax in questions is less than $10,000 and if the taxpayer "has paid any tax liability for the three preceding taxable years". If I understand this provision, I think it goes much too far. However, T2 is correct in suspending the failure to pay penalty while an installment agreement is pending, and I do not take exception to its proposal for 30-days notice by IRS if an agreement is denied or terminated. The exception for cases in which collection of tax is in jeopardy should meet IRS' administrative needs. In my judgment, any gain by

providing an administrative appeals structure is outweighed by additional costs.

3. *Interest*. T2 would extend the provisions permitting abatement of interest, and would extend the interest-free period for payment of tax after notice of demand from 10 days to 21 days. I am concerned about these provisions, particularly that calling for mandatory abatement for small taxpayers. Small taxpayers deserve to be treated exceptionally reasonably and fairly, but I don't think this should extend to interest-free loans from the Federal government to those who haven't paid their taxes. While some of the changes seem worthy, I suggest you move cautiously here to preserve equity while forestalling another rash of lawsuits.

4. *Joint Returns*. These provisions are all right with me in principle. As to technical issues, I believe that the American Bar Association will comment.

5. *Collection Activities*. This is the most sensitive area, as I see it. The Internal Revenue Service has been heavily criticized for not being an efficient bill collector, and recently some have wanted to privatize collection of taxes. Perhaps on the basis of obsolete information about how private bill collectors go about their jobs when they are paid a percentage of the amount collected, I think that if collection of taxes were privatized, within a very few years taxpayers would be beseeching Congress to give the job back to the IRS. In the past the IRS has not been fully consistent in its collection stance either from time to time or from one locality to another. Some districts have been hard-line and some have taken a much softer approach. Surely the IRS should strive to prescribe uniform and reasonable rules and apply such rules uniformly throughout the country. But curtailing IRS powers to collect taxes means, to me at least, that less taxes will be collected and more will be written off. Again, we have a balancing problem.

My specific comments are as follows:

(a) *Withdrawal of Lien Notices*; Why not? (But we need administrable standards.)

(b) *Return of Levied Property*; Why not?

(c) *Increasing Exemption Levels*; Why not?

(d) *Expanding Authority to Accept Offers in Compromise*; Clearly $500 is too low, but $50,000 may be high. Given possible integrity and other problems, I would settle for $30,000. We can always increase the ceiling further if needed.

(e) *Notice Before Examination*; Is this really needed? What happens if the notice is defective?

(f) *Limits on Recovery of Civil Damages*; $200,000 would be plenty. Raising the level to $1 million would encourage bounty-hunting by contingent-fee lawyers whose practice will soon be diminished, I hope, by the enactment of long-needed legal reform.

(g) *Review of Designated Summons*; I think this should be left to the IRS; is this legislation really needed?

6. *Information Returns*. While I think that taxpayers receiving information returns should be provided with access to those issuing returns in order to clear up questions, this proposal raises questions which, at this very preliminary stage, I am unable to evaluate. What effect would an incorrect telephone number have on the information return? On balance, I would strongly encourage

the IRS to seek to provide taxpayers with what they need, but I would hesitate to put it in the law until further consideration. Moreover, I would extend the effective date until 1996.

7. *Civil Damages for Fraudulent Information Returns;* Why not?

8. *Requiring IRS to Make "Reasonable Examination" of Information Returns;* Given the enormous volume of information returns, I think this goes too far.

9. *Section 6672 Penalty.* The exception for jeopardy situations makes the proposed requirement of preliminary notice rules of somewhat less concern, but on balance, I question whether it is needed.

10. *Warnings and Notification Requirements.* If my understanding is correct that taxpayers may not use the lack of warnings to escape the 6672 penalty otherwise due from them, then I don't object to the warning provisions. However, I have substantial doubt about whether the notification requirements are administrable, and I recommend they be dropped. Both of these issues are better handled without legislation.

11. *Litigation Costs and Fees.* I would increase the cap as recommended but omit the other changes.

12. *Other Provisions.*

(a) *Required Content of Notices.* Provided the proposed change doesn't give rise to wholesale invalidation of notices, it seems all right.

(b) *Substitute Returns.* Seems fine.

(c) *Retroactivity of Regulations.* Although I certainly don't agree with Treasury and IRS all the time about their substantive pronouncements or, in a very few cases, about their respect for the rule that sound tax administration calls for fairness and leniency in selecting the effective dates of regulations, I don't think that the proposed changes are a good idea. Let's caution the administrators to turn square corners with the public, but in this situation, as in many others, it is better to leave the law where it is. Through oversight hearings and correspondence Congress can see to it that the administrators try to do their jobs correctly. I am particularly concerned about the proposed effective date of this provision: Eliminating retroactivity of regulations would be implemented retroactively.

(d) *Required Notice of Payments.* How about 90 days?

(e) *Unauthorized Enticement of Information.* Unless I am missing something, this seems all right.

13. *Form Modifications.* Let's leave this to the administrators and ask them at oversight hearings and otherwise what they are doing to make sure that taxpayers are fully informed.

14. *Studies and Reports.* Same comments as above. Besides, I don't think a law is needed for Congress to communicate with the General Accounting Office about Congressional needs and priorities.

Chairman JOHNSON. Thank you.
Mr. Cohen.

STATEMENT OF SHELDON S. COHEN, PARTNER, MORGAN, LEWIS & BOCKIUS (FORMER COMMISSIONER, INTERNAL REVENUE SERVICE)

Mr. SHELDON COHEN. Thank you, Madam Chairman. I would associate myself with just about everything that my colleagues have said on the taxpayer advocate, I think it is important. The commissioner goes around the country saying, "I am the only political appointee in this system." I think that is important. I think that is useful. I think it breeds confidence.

As to the innocent spouse, joint liability, I was there. The case that gave rise to innocent spouse came up when I was there and I proposed that legislation.

I think that what has been proposed to you is more far reaching than has been discussed here. And I think you need to go into that in a lot more detail before you dive into a pool where there may be some fish that you do not want to be in the pool with.

As to attorneys' fees, I have not personally had a problem. But I would agree that if the government goes down in blazing defeat that is the appropriate time for it to justify itself.

On equity jurisdiction, I once said before the Appropriations Committee when one of the members put the question to me, should I have equity jurisdiction? I said, yes, I have absolute confidence in my own judgment. I said, but on the other hand, I do not have confidence necessarily in those who might replace me. So maybe you had better not give it to me either.

So you have to be very careful about giving equity—do you want the Revenue Service to respond to a sad story? It may, it may and it may do it in a way that you do not like and then your oversight is going to be all over them.

So I would think long and hard about too much equity jurisdiction. Giving me equity is to do a dis-equity to everybody else. Because they have complied with the law.

[The prepared statement follows:]

TESTIMONY OF SHELDON S. COHEN
BEFORE THE
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES
SUBCOMMITTEE ON OVERSIGHT
MARCH 24, 1995

Madam Chairman and Members of the Subcommittee on Oversight:

My name is Sheldon S. Cohen. I am a partner in the law firm of Morgan, Lewis & Bockius in the D.C. office. I am delighted to appear before your Subcommittee today to give you my personal views on a possible expansion of the **Taxpayer Bill of Rights.**

The Congress has visited this area -- of protecting the rights of taxpayers from real or perceived ills -- since the original Taxpayer Bill of Rights became law in 1988. Several members of this House and of the Senate have from time-to-time suggested changes to further expand the rights of individual taxpayers during audit or collection activities. H.R. 11 was included in the Revenue Act of 1992 but was vetoed by President Bush and thus never became law.

I would like to discuss a few of the provisions of H.R. 11 which I believe should be modified and one new idea which has been raised recently which would require the government to bear the burden of proof in all tax situations.

I would remind the Committee that I served in the Internal Revenue Service on several different occasions. During the period 1952-1956, I served as a legislative draftsperson during the drafting of the 1954 Code and Regulations. In the period January 1964 through January 1969, I served as Chief Counsel for one year and Commissioner of the Internal Revenue Service for four years. I have also served as a Trustee of the National Academy of Public Administration and have served as a panel member of several studies for the administrative aspects of the Internal Revenue Service. I also served as Co-Chair of a study of the collection and privacy portions of the Internal Revenue Code for the Administrative Conference of the U.S. (The changes recommended by that group, co-chaired by Justice Scalia, were adopted by the Congress in 1976.)

The object of the **Taxpayer Bill of Rights** is salutary. Every taxpayer, in dealing with his government, should be treated fairly and courteously. There is no excuse for overbearing or harsh behavior on the part of any government official in dealing with any taxpayer. Most IRS employees do their jobs fairly. When I was Commissioner, I emphasized this -- that the good taxpayers deserve it and those that try to game the system will be confounded by fair treatment.

Nevertheless, as you can understand, the job of tax collection is tough and trying. There are many occasions where either or both the taxpayer and the IRS employee's nerves will be frayed, and they will annoy each other. Because an IRS employee occasionally annoys a taxpayer is no reason to give that taxpayer rights any better than any other taxpayer. To treat one taxpayer in a beneficial manner more favorably than another is to prefer one taxpayer over the other. This is unfair and creates hardship for other taxpayers.

Thus, I do not favor the waiving of interest as provided in H.R. 11 for "any assessment of a deficiency attributable in whole or in part to any error or delay by an officer or employee of the IRS..." may be abated. It is hard for me to see why a taxpayer should pay no interest even if the IRS unreasonably delays performing a managerial or ministerial act. The taxpayer had use of the money and could have had it in an interest-bearing account. Thus, I would use a fair interest rate. If you charge no interest, you benefit one taxpayer over the other.

I am troubled by the creation of a new Presidential appointee to serve as Taxpayer Advocate. Since the 1952 Reorganization of the IRS there has only been one Presidential appointee in the IRS, the Commissioner of the Internal Revenue.[1/] Prior to 1952 there were numerous Presidential appointees and each was appointed with the recommendation of the

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1/ The Chief Counsel is technically an Assistant General Counsel of Treasury assigned as Chief Counsel of IRS.

usual political sources. This lead to problems in the 1950s and lead to the so-called "Blue Ribbon" System we have now. If the Congress wishes to have a Taxpayer Advocate, this can be done, but there would appear to be no necessity to set up a position of such high rank which might become enmeshed in politics. I have enough confidence in this Committee's action over the years to believe it can properly monitor the role of the Taxpayer Advocate.

The Congress has from time-to-time criticized the IRS for its failure to collect all the taxes due. At other times the Congress has criticized the IRS for acting too harshly in collecting the taxes which are due. You must remember we are talking about taxes which are due or overdue and what is really necessary is determining whether the taxpayer has the capacity to pay more quickly or more slowly. Reasonable people may well disagree on these points. Reasonable notice by the government as to the change of an installment agreement may be required but not too much. Please remember the situation is very fluid and delay may cause failure to collect. That burdens the taxpayers who comply.

In regard to the provision regarding possible personal liability by an IRS employee, the House has earlier proposed such a provision. The Senate did not. The Bill as passed had no such provision. I would hope that you would go along with the Senate version again. Otherwise, you will inhibit IRS employees from acting on their best judgment on the threat of possible personal liability. The liability may not be real, but it will inhibit reasonable action out of fear. This will not be constructive for the administration of the tax laws. Likewise, it will not benefit the taxpayer as the law already gives him/her a right of reimbursement against the government.

In regard to retroactive regulations, taxpayers like them when they are favorable but violently disagree with them when they may be tighter than they want. The interpretive regulation is different from the legislative regulation. Assume the Congress passes a new provision and the Treasury issues a notice of rule making a year later -- then waits a year to complete the final regulation. The interpretive regulations merely interpret the law; it should be effective from the date of enactment assuming the courts find it to be a reasonable

interpretation. In most instances where the regulation takes a sharp departure from a prior position of the IRS, the regulations are prospective only. Likewise, most legislative regulations are prospective.

There are problems when a notice has been issued and the regulations are finalized years later. In such cases, then taxpayers often complain that they are harmed by the retroactivity of the regulation. How about the majority of taxpayers who go along with the Treasury's proposed position -- Are they harmed if you had a rule of no retroactivity. I think the compliant taxpayer would be hurt. He has followed the rule the Treasury suggested as right, but the person who pushes the edges gets the benefit of delay. I would not go for such a rule. Regulation can be fair even when applied retroactively. I don't think you can write a statute which gets it exactly right. There is too much judgment involved.

The area of the erroneous 1099, K-1 or the like is troubling. It would be good to work out a system to test these; however, it seems difficult to me to allow any taxpayer to contest the correctness of a 1099 by bringing in other taxpayers. Some system of allowing a taxpayer to prove to the IRS that the information return is in error should be allowed. I am not sure this is a prevalent problem. Certainly, the filing of a fraudulent 1099, K-1 or the like is now subject to penalty under the criminal sector of the law. I'm not sure you need more.

Another item should be raised. Some people have suggested it is inappropriate to have the taxpayer bear the burden of proof in a tax case. They assert that the government shall bear the burden of proof in all tax matters. This suggestion, while sounding nice, is quite illogical. In our self-assessment system, the taxpayer has the records and makes a self-assessment; that is, he asserts his position on his return. If the government disagrees with that position, it asserts a deficiency which the taxpayer can litigate in the courts. Historically, the first right to litigate was by way of refund. That is the

taxpayer was required to pay the tax and sue for a refund. The taxpayer, being the moving party, therefore bore the burden of proof. Next with the introduction of The Board of Tax Appeal and later the Tax Court, the taxpayer was allowed to litigate before paying, but the burden of proof stayed with the taxpayer. Thus since the inception of the first income tax in 1862 (proposed by President Lincoln), the burden has been on the taxpayer.

Now I can tell you as a litigating lawyer in private practice, I would love it if the government always had the burden of proof. But that is not fair nor is it practical. If you enact such a rule, it will dramatically effect the efficiency of the system and will result in lower collections. Think of a system where the taxpayer has all the records and the government has to prove the case. If the government has access to the records, it will demand them all (more than it really needs) just to protect itself. That would be costly and ineffective on both taxpayers and the government. On the other hand, perhaps this rule would deny to the government the records altogether. Then the tax system would be a shambles.

Although I have a personal interest in making it tough for the government (after all, I represent taxpayers now), I do not believe a change in the burden of proof would help the system in terms of fairness or effectiveness.

I have not discussed all the provisions of H.R. 11. If you would like my views on any specific provisions I have not covered, I would be pleased to address them.

Chairman JOHNSON. Well, thank you, Mr. Cohen. I think that is a very wise comment to make to us at this point. And I think every member, when they are first elected to Congress, one of the reasons I am opposed to term limits is that it is hard to understand this issue of equitable implementation nationwide.

And what fell on one of my constituents is clearly it outrageously inequitable. I could see, over time, clearly was better than the inequities that would result if we gave too much latitude in the implementation and the enforcement of tax law.

On the other hand, I do think this issue of what happens in some of these postdivorce situations is serious enough and the inequities that are resulting are serious enough that we need better guidance.

Mr. SHELDON COHEN. Oh, yes. I do not dispute that. I just say that——

Chairman JOHNSON. I would be happy to have your comments on the other side, because I think the recommendation to simply repeal this always has unintended consequences. So if you want to give us your thoughts on that particular issue, feel free to follow-on and do that. And that goes for all of you.

Thank you very much for your written testimony which we have reviewed, at least some of us have already reviewed, and it will be helpful to us as we move forward.

Thank you.

And after this vote there will be then one more vote with no time lag to speak of. So it will probably be about 15 minutes before the members are able to assemble for the final panel. I apologize for the delay.

[Recess.]

Chairman JOHNSON. My apologies for the delay but business is done around here in this kind of fractured manner all the time.

I am going to, in turning to the next panel, ask Mr. Lane to go first on behalf of the National Association of Enrolled Agents. We appreciate your testimony, Mr. Lane, and we know you have to catch a plane. So we will hear from you first and then the others in succession.

I do appreciate, very much, the panel members patience and the fact that you are all still here.

Mr. Lane.

STATEMENT OF JOSEPH F. LANE, ON BEHALF OF THE NATIONAL ASSOCIATION OF ENROLLED AGENTS

Mr. LANE. Thank you, Madam Chairman.

We have submitted written testimony and I am sure the committee has heard a lot today and I would be happy to submit my written testimony and just provide some additional comments rather than to go through all of it, if you would prefer?

Chairman JOHNSON. For all of you, your entire statement will be included in the record, that is our tradition. But we try to limit the opening statements to five minutes, and usually you are better off summarizing, particularly at this point, because you have heard the rest of the testimony, and giving us your thoughts on those other discussions.

Mr. LANE. Ok. Basically with respect to the tax ombudsmen issue, we think that the political culture within the Service would

not really allow a political appointee to effectively work as well as the current problem resolution function does.

And I think if the concern of the Congress is that they are not getting accurate information and they are not getting the types of reporting that they would like to have, then probably the best thing to do would be to address that issue much along the lines that Commissioner Gibbs suggested, that by having open hearings each year, for example, on the number of ATAO's that were issued and the interventions that problem resolution did provide for taxpayers.

But as taxpayer representatives, we feel that PRP functions fairly well and has been able to stop the enforcement divisions in their tracks when we need to have them stopped and most of the time it works.

I think the inclination of having a separate bureaucracy set up outside of the Service that the practitioners would have to deal with just provides another level of interface which I do not think really helps the taxpayers.

Now, we agree on the installment agreement provisions with one exception. We would like to see the bill amended to provide the right to an installment agreement to taxpayers that have even been delinquent in the last 3 years.

Chairman JOHNSON. Excuse me, I did not understand. The right to?

Mr. LANE. The bill proposes a right to an installment agreement.

Chairman JOHNSON. Yes, the installment agreement.

Mr. LANE. But the language in the bill says that the taxpayers had to have paid all the taxes, at least one out of the last three years, on time. There are a lot of people who, because of the withholding tables—for example, a couple that worked for minimum wage, if they both were claiming married and two they would be under-withheld when they file that joint return. And they need an installment agreement to catch up on last year's taxes.

The fact that that is just an accident of the way the tables work I think it unnecessarily penalizes those people to deny them the right to an installment agreement, and subject them to the additional late payment penalty.

Whereas if they had an installment agreement privilege they would not be charged, as the bill now proposes, with the late payment penalty.

So we would like to see that changed.

We agree with Professor Beck's proposals on the joint and several liability. I think that needs to be addressed. Clearly, that comes back to haunt a lot of us, especially out in community property states. We've got significant problems when IRS is trying to go after a new spouse's earnings on that to pay off prior liabilities. That really does complicate things.

On the collection activities, we agree with the ability now to withdraw an erroneously or prematurely filed lien. And we would also like to see additional restrictions put on Service employees who are employed in the automated collection sites, the ACS sites, or their replacement sites, the new taxpayer service sites, from being able to put liens on accounts without some better managerial review than they currently are subjecting them to.

One of the problems we have is we have these people who are trained very, very superficially on the impact that a tax lien has on a taxpayer's credit ratings. And they file these liens. And by the time the case gets to the field, the lien is already on file and it really complicates the ability of the taxpayer and the tax practitioner to be able to resolve that case using commercially available credit resources.

So it forces these people into very much more expensive installment agreements with the Service. And it is not to anybody's benefit to do that. It runs your accounts receivable inventory up and it hurts the taxpayer.

We would like to see the third party recordkeeping requirements extended to enrolled agents, just as CPAs and attorneys now have it.

One of the other concerns that we have is about H.R. 390. We think that is really a mistake. That legislation, which on the surface, appears to be mom and apple pie, really ought to be titled, the Tax Evasion Enabling Act of 1995. I mean it really complicates the process for the Service to administratively resolve these things.

What it does is this. It takes the burden off the taxpayer who files the tax return to provide the documentation, and puts that burden on every other taxpayer they did business with during the year. Because instead of having the intrusion between the taxpayer who filed the tax return and the Service auditing him, the intrusion now involves every other taxpayer that the Service has to involve to document the audited taxpayer's expenses or income. It really is not a fair process.

We have some additional suggestions for improvement and areas of concern. We think that any Taxpayer Bill of Rights ought to address the fears that the Service stirs up with taxpayers when they announce new programs.

There are a couple of changes that they recently announced that obviously are causing a lot of people concern. In the collection function, they have implemented user fees on people that require installment agreements.

As we heard in testimony at the rulemaking hearing, in January at IRS, if you had a taxpayer who worked for minimum wage, this user fee that they are now charging to let this guy have an installment agreement is 2 days pay.

That is an outrage. These are the people who can least afford to pay. When you consider the tax, the interest, and the penalties that they are paying, the interest and penalty charges, in total, would be usurious under state law, anywhere in this country. The only reason they are not is because the Federal Government is charging them.

But to tack on an additional $43 user fee is outrageous and we think that ought to be taken back.

The other program that is stirring a lot of concern up lately, with practitioners and taxpayers alike, is this new announcement that they are going to be pursuing the economic reality, or lifestyle audit. And that has got a lot of people concerned about why IRS needs access to all of their financial data and whether or not they are going to be using credit reports.

Obviously they are concerned about the abuse potential that exists. The practitioners are concerned because one of the key elements——

Chairman JOHNSON. Lifetime audits——

Mr. LANE. Lifestyle audits. In other words, what the Service is going to be looking at is the economic reality of that taxpayer. What they have said in their publications is that they are no longer auditing the tax returns, they are going to audit the taxpayer.

In other words, if you have got $30,000 on your return, how do you have a $400,000 house? Those types of questions. And all of their auditors are going through training right now on that topic. They are going through a 32-hour training course this month and last month.

The concern in the practitioner community—and I think it will probably be voiced by other people on this panel today—is that one of the key elements of the 1988 Taxpayer Bill of Rights Act was the absolute right of taxpayers to have representation and the right of those representatives to stand in the shoes of the taxpayers.

The way that these economic reality audits are being constructed, the advice the Service is giving to their auditors is that when it comes to lifestyle questions, the representatives are really not equipped to answer it and a taxpayer has to be present at the audit.

So that is going to stir up that whole issue we thought we finally had buried years ago. I think everybody probably will reflect the same concern.

Those types of announcements and programs that get introduced get people stirred up. I think that the key element of all of these Taxpayer Bill of Rights proposals ought to be that the Enforcement Divisions of the Service are able to do their job with the least amount of impact and adverse harm on taxpayers that they come in contact with.

That ought to be the over-arching goal of all of these proposals and changes.

I would be happy to take any questions you may have.

[The prepared statement follows:]

TESTIMONY OF JOSEPH F. LANE
NATIONAL ASSOCIATION OF ENROLLED AGENTS

Madam Chair Johnson, Ranking Member Matsui, members of the Subcommittee on Oversight, thank you for the privilege of testifying today. My name is Joseph F. Lane and I am an Enrolled Agent engaged in private practice in Menlo Park, California. Prior to commencing private practice fifteen years ago, I served with the Internal Revenue Service for almost ten years. While with the Service, I served at the District Office, Regional Office, and National Office levels and was the Collection Division Chief for the State of Hawaii, the Taxpayer Service Division Chief for the State of Connecticut, and the Resources Management Assistant Division Chief for the Manhattan District. I am here to testify on behalf of the National Association of Enrolled Agents (NAEA).

NAEA appreciates the opportunity to testify on behalf of its approximately 9,000 Enrolled Agent members and to speak for the individual and business taxpayers whom we represent. Enrolled Agents are professional individuals whose primary expertise is in the field of taxation and taxpayer representation. As the Committee members well know, the Enrolled Agent profession was created by an Act of Congress in 1884 to provide for competent and ethical representation of claimants before the Treasury. We are proud to say we have been diligently fulfilling this role for the American taxpayer for the past 111 years.

Enrolled Agents establish their expertise in taxation and taxpayer representation by either passing the Internal Revenue Service's comprehensive two-day examination on federal taxation or by serving as an IRS employee in an appropriate job classification for at least five years. NAEA members maintain their expertise by completing at least 30 hours of continuing professional education each year. Our members work with more than four million (4,000,000) individual and business taxpayers annually.

It is in our role as the voice for our members and for the general taxpaying public that NAEA submits this testimony on a proposed Taxpayer Bill of Rights 2.

Our testimony is prepared following the outline of the major titles of H.R. 661 for ease of reference and is as follows:

Title I - Taxpayer Advocate

We have reviewed the proposal for the establishment of the Office of the Taxpayer Advocate within the Service and have several concerns about this suggestion. We do not see a clear benefit from replacing the current Taxpayer Ombudsman position with the new Taxpayer Advocate position.

It is our feeling as taxpayer representatives that the Problem Resolution function as currently organized serves the taxpaying public well, is responsive to taxpayer complaints, and is endowed with sufficient ability to effect changes in the direction of action proposed by the enforcement divisions. It is not clear from the proposed language in the Bill if this Taxpayer Advocate would be a political appointee, although the mention that he or she would be compensated at the same level as the Chief Counsel would seem to indicate that this individual would not be a career Service executive.

We believe the organizational culture of IRS would severely inhibit the effectiveness of any political appointee placed in charge of a Service-wide network of career civil servants such as the Problem Resolution function. It would be far preferable to maintain the current structure, which, at least, has the benefit of wide-spread support within the Service and work to improve the reporting mechanisms back to the Congress if that is of concern. With respect to the Annual Reports due the Committee, we feel the Bill's approach is in error when it does not permit the Commissioner's staff to review and comment. If the Congress believes that it is not getting accurate information from the Commissioner, it has the ability to ask the GAO to study the question or verify the data. We question the advisability of requiring an employee of the Commissioner to prepare

"secret" reports to the Congress without coordination within the agency. Any proposal which sets up the Taxpayer Advocate function to be viewed as adversarial to the rest of the Service will be counterproductive to the Bill's intent.

Title II - Modifications to Installment Agreement Provisions

We agree with the proposed changes in the installment agreement section of the Bill with the exception that we believe that the right to an installment agreement ought to be extended to all taxpayers, even those who may have been delinquent in the past three years. Many installment agreement taxpayers are married couples earning minimum wages who discover to their dismay that the withholding tables leave them under withheld when they combine their wages for tax reporting purposes on their joint return. Many of these people have had installment agreements each year to finish paying off their prior year's liability. The fact that they have had taxes due each of the prior three years should not bar them from having the right to an installment agreement, especially since the only really practical way of collecting from these people is by installment agreement. Since this is the case, why make these people subject to the additional penalty charges which will accrue on their account?

We support the proposal to suspend the running of the failure to pay penalty during the period of the installment agreement. This gives real incentive to taxpayers to stay current with their installments, provides very real relief from the "crushing" accumulation of interest and penalties and restores the taxpayer involved to the ranks of compliant taxpayers sooner. The only change we would like to see is that this penalty relief be extended to those taxpayers in notice status after assessment and not just those taxpayers who request an installment agreement on or before the due date of the return. As currently drafted, the Bill provides an advantage to the taxpayers who have professional tax practitioners prepare their returns. They will be advised to request an installment agreement when they file. Those taxpayers who prepare their own returns or who may not be able to afford professional assistance would find out too late that this relief provision was available. This would place taxpayers least able to afford it at a disadvantage.

We also support the proposals which establish a notice requirement and a review process in the event the Service decides not to extend an installment agreement to the taxpayer. We urge the Congress to define what constitutes jeopardy situations wherein the Service can disregard the notice requirements required by the Bill. In our experience, what Service employees define as jeopardy situations often fail to meet any objective understanding of the term, in any judicial sense of the word.

Title III - Interest

We agree with the proposed modifications to the law governing interest due and applaud the extension of the interest free period for payment of tax after notice and demand is given. The ten day provision has long been unreasonable. We would like to see the period extended to thirty days. We would also like to see special provisions for extension of the interest free period beyond the thirty days if it can be demonstrated that the taxpayer had no knowledge of the assessment ever being made and had not received notice and demand.

Title IV - Joint Returns

We endorse the proposal to permit disclosure of collection activity data to the joint parties of the assessment. This is a change which has long been overdue in terms of equity to taxpayers and in terms of permitting the Service to defend its actions on cases.

Title V - Collection Activities

The proposals to permit withdrawal of prematurely or erroneously filed Notices of Federal Tax Lien are excellent. In addition, we would like to see restrictions on the ability of Service employees in the Automated Collection Sites or the replacement Taxpayer Service Centers to file Notices of Federal Tax Lien without proper managerial reviews for appropriateness and suitability. All too often, liens filed by ACS prevent taxpayers and their representatives from utilizing commercial credit sources to retire tax debts thereby necessitating more expensive installment agreements with the Service, a situation from which neither the Service nor the taxpayer derive any benefit.

The increased levy exemption amounts are too low, in our opinion. The amount of personal effects exempt from levy ought to be $2,500.00 with additional annual adjustments as proposed for indexing inflation. The tools of the trade exemption ought also to be $2,500.00, with future indexing. In addition, a business vehicle such as a truck or specially adapted vehicle ought to be allowed to be excluded up to the levy exemption amount. The Service currently maintains that the levy exemptions do not apply to motor vehicles, regardless of their manner of use.

We agree with the modification requiring District Counsel review on Offers in Compromise over $50,000.00. The prior threshold amount of $500.00 was absurdly low and contributed to a backlog in processing cases efficiently.

We agree with the provisions which would increase the limit on recovery of civil damages for unauthorized collection actions.

We would like to see the definition of third party record keepers extended to Enrolled Agents for purposes of the administrative summons provisions.

We would note that under Circular 230, Enrolled Agents have the same professional rights and responsibilities with respect to their practicing before the IRS as do attorneys and certified public accountants.

As I mentioned earlier, an individual does not become an Enrolled Agent without first demonstrating special competency in tax matters. This may be achieved by working for the IRS as a tax specialist for a minimum of five years or by passing a rigorous examination. This demonstration of competency is similar to that imposed on attorneys and certified public accountants. Furthermore, Enrolled Agents are required to maintain their competency through 30 hours of continuing professional education each year. Again, this parallels the continuing education requirements for certified public accountants and attorneys.

Finally, Circular 230 requires persons maintaining records for others to assist the IRS in the agency's efforts to conduct legitimate and effective investigations. Under Section 10.23 of Circular 230, Enrolled Agents, as well as attorneys and certified public accountants, may not unreasonably delay the prompt disposition of a matter before the IRS. Also, to the extent a client of an Enrolled Agent, attorney, or CPA has knowledge that a client has violated the revenue laws of the United States, that professional is required to promptly advise the client of the omission.

This revision would provide fair protection to taxpayers and to their representatives without causing undue restrictions on the Service.

The imposition of Counsel review in the case of corporate summons issuances is a good change, as is the requirement of notice to the corporation of summons issuances to other persons in connection with the corporate audit.

Title VI - Information Returns

The proposal to establish civil damages for fraudulent filing of information returns is long overdue and should be enacted. We have seen many innocent people, both taxpayers and government employees damaged by these fraudulent filings. It is important to insure that these violators are prosecuted to the full extent of the law. Of course, our support for this new provision goes hand in hand with the inclusion of the new proposed subsection which requires the Service to conduct reasonable investigations of information return disputes.

Title VII - Modifications to Penalty for Failure to Collect and Pay Over Tax

The proposed changes relating to proper notification are good changes. We have all seen cases where no prior notice was provided to taxpayers before assessment and taxpayers were ill-equipped to defend themselves years later due to unavailability of records.

We would like to see additional language in the statute providing exactly when the statutory period for assessing the Trust Fund Recovery Penalty commences and expires. For many years, there was common agreement between the Service and the practitioner community that the period for assessment was three years from the presumptive filing date of the employment tax returns from which the liability arose. The Service in recent litigation has tried to make the case that the Trust Fund Recovery Penalty does not arise from any particular employment tax return and therefore is not subject to the three year rule but rather that there is an "open" statute of limitations. Despite a decades long record of representing in court after court and case after case that the three year statute of limitations rule applied to Trust Fund Recovery Penalty cases, the Service is now contending that the Trust Fund Recovery Penalty is a "separate and distinct" liability from the employment tax liability of the employer entity. Taking this position means that there is no Internal Revenue Code Section 6501 (a) limitation period trigger. The Service is maintaining that since Congress never specified that Section 6501(a) or any other statute of limitations should govern Section 6672 assessments, there is no statute on these assessments. We do not believe this was the original intent of Congress and neither did the Service for many years. We urge Congress to put this flagrant ruse to an end immediately by stating in this Taxpayer Bill of Rights legislation that the Trust Fund Recovery Penalty assessments are subject to the statute of limitations provisions and requirements of IRC Section 6501(a).

We support the proposal to permit disclosure of information to other persons assessed the same Trust Fund Recovery Penalty concerning the status of IRS efforts to collect from fellow assessees. We believe that this change will insure a more even-handed collection effort by the Service - which in the past has tended to pursue the easily available parties disproportionately.

Title VIII - Awarding of Costs and Certain Fees

We support the proposed modifications for motions for disclosure of information and for the increase in attorney's fees.

Title IX - Other Provisions

The proposal to grant relief from retroactive application of Treasury Department regulations is acceptable provided that the section providing the taxpayers with the right to elect retroactive application is also approved. This would permit taxpayers to avail themselves of beneficial rulings.

We also support the requirement to notify taxpayers of payments which the Service cannot identify and associate properly with their account.

The new provisions for civil damages for unauthorized enticement of information disclosure appear to be acceptable.

Title X - Form Modifications; Studies

We particularly note the importance of the Congressional oversight of IRS employee misconduct. We urge that the Service be required to report to the Committee on an annual rather than a biennial basis. In addition, we urge that the Privacy Act be amended to permit reports back to taxpayers and their representatives regarding specific allegations of employee misconduct brought to the Service by taxpayers or their representatives once the Service has reached a final determination and personnel actions have been taken. This process insures taxpayers and the practitioner community that the Service follows through on allegations of employee misconduct and subjects employees to disciplinary actions when deemed warranted.

Comments on H.R. 390 : "Burden of Proof"

We have reviewed the provisions of H.R. 390 and find that the proposed changes with respect to shifting the burden of proof in civil cases from the taxpayer to the Secretary are much too radical. If Congress is seriously giving this proposal consideration we believe all taxpayers have serious cause for concern about the stability of our taxation system. **If we only represented tax evaders we would whole-heartedly endorse this proposal!** But we represent millions of compliant taxpayers who diligently maintain their books and records, compile their annual tax return data and self-assess themselves. These taxpayers are the rock-solid base of our entire voluntary compliance system. It is for these taxpayers that we register our concern about the proposed changes sought in H.R. 390.

If this change is adopted, the Congress shifts the burden for proving any one taxpayer's income or deductions not only from that individual taxpayer to the Service but also to every other taxpayer and business entity the individual being audited transacted business with in any given tax year. The record keeping requirements would far exceed anything imaginable under our current system and would cost all taxpayers far in excess of the amount they now expend. Aside from the essential unfairness of expecting everyone else the taxpayer deals with to assist the Service in making proper tax determinations, we also feel that the basis of our system assumes that taxpayers will have records to support the self-assessments they file. They are, afterall, the ones who had the income and the expenses and are best in the position to establish, at the least cost and time, what those items were.

We believe the Internal Revenue Code, as presently structured, provides manifold safeguards for taxpayers to administratively proceed through the Service and Courts to arrive at correct tax determinations. The Congress should be very wary of changing procedures as fundamentally as those proposed in H.R. 390 because the consequences on taxpayer compliance with such drastic change cannot be accurately predicted or measured.

Additional Suggestions for Improvement

We are encouraged by the prompt attention shown to the issue of Taxpayer Rights by the 104th Congress. Many of the areas addressed in the proposed legislation were addressed in H.R. 11 and deserve to be brought back on the table now. We have provided our frank opinions on these issues and made suggestions where we felt the proposed legislation needed additional emphasis.

Whenever we are addressing the issue of taxpayer rights, we think it appropriate to point out that the really serious matters regarding taxpayer interface with the Service occur at the enforcement Division level. Taxpayer concerns run highest when forced to deal with the reality of being audited or owing taxes. We believe any effective, worthwhile Taxpayer Bill of Rights will address concerns about how these Divisions carry out their responsibilities while at the same time inflicting the least possible harm on the taxpayers involved.

By way of illustrating taxpayer fears we feel should be addressed by any Taxpayer Bill of Rights, we offer the following procedures or policies the Service recently embarked upon or announced which have heightened concerns among taxpayers about their vulnerability in dealing with Service employees. For example:

- The Collection Division is in the process of developing new procedures to be employed when evaluating the taxpayer's ability to pay delinquent taxes. These new procedures, which concentrate on determining what are necessary monthly expenses and what constitutes reasonable amounts for those expenses, are an attempt to satisfy GAO criticisms about the Service being "too lenient" when determining taxes are currently not collectible. The new approach basically relies on Bureau of Labor Statistics data about family expenditures to set standard expense levels for taxpayers. We believe this process would be acceptable if the taxpayers could not document their true level of expenditures and the Service relied on the BLS data as a base. We disagree about using these statistics when taxpayers have ample documentation about their family expenditures to offer in their stead.

- The Collection Division has recently implemented a "user fee" charge on taxpayers who require installment agreements to pay off their delinquent taxes. We opposed this "user fee" in our testimony before the Service's committee on the proposed rule making and oppose it again here in our testimony. We think user fees ought to be prohibited for installment agreements. Taxpayers who need to pay on installment already pay interest and late payment penalty charges which would be considered usury under most state laws. To heap on them yet another charge for the cost of servicing their account is an outrage. To put it in perspective for the Committee, if the taxpayer is working for the minimum wage, the user fee is approximately two days pay!

- The Examination Division has recently announced the commencement of "economic reality" audits whereby the taxpayers, not the tax returns, will be audited. This interest in the taxpayer's lifestyle has aroused a great deal of concern among taxpayers. Taxpayers are fearful of their every financial transaction being scrutinized by the Service, apprehensive about their credit files and other financial data being subject to Service review on a wholesale basis, and frankly concerned about Service employees abusing the right to inquire into their financial records. We cannot fault the Service for seeking to make its audits more productive or for its effort to search out undeclared income - after all that is the primary mission of the organization and as taxpayers we support them. But, at the same time, we have grave concerns about the potential misuse of this confidential taxpayer data and concerns about who in the Service gets to decide in what circumstance the expansion of an audit into questions of lifestyle is appropriate. We also would like to see a requirement that the taxpayer be informed at the onset that the audit will delve into lifestyle issues.

- There is a great deal of speculation among the practitioner community that one of the primary motivations of the Service in choosing to 'audit" the lifestyles of taxpayers is that it provides a way to bypass the practitioner and get directly to the taxpayer thereby defeating one of the primary provisions of the Taxpayer Bill of Rights - the right of the taxpayer to secure representation and the right of the representative to "stand in the shoes" of the taxpayer. The IRS training manuals

for economic reality auditing provide guidelines for auditors that suggest that only the taxpayer is able to respond to "lifestyle" issues and therefore their presence at the audit should be required. This viewpoint obviously has taxpayers and their representatives concerned about IRS intentions for these cases.

Again, the members of NAEA thank you for this opportunity to present their views to the Subcommittee on these important issues. We offer our assistance to provide any additiional information raised by these comments or other areas of concern.

Chairman JOHNSON. Are there questions of Mr. Lane since he has to leave?

[No response.]

Mr. LANE. Actually I will have to leave probably sometime during this panel but I do not have to run right now. I will be here probably about another 40 minutes.

Chairman JOHNSON. Well, I will give the members a chance. Your comments have been very helpful and have gone to a lot of things that have been raised.

Mr. LANE. Thank you.

Mr. PORTMAN. Thank you Madam Chairman. First of all, Mr. Lane, I appreciate your testimony. You have seen it from both sides based on your brief bio at the beginning of your statement and therefore, your statement has particular credibility.

Now, just on the burden of proof for a moment, are you saying flat out, the burden of proof should not be shifted in any of these civil cases, and that there is nothing we can do short of an entire shift to address some of the concerns that have been raised earlier?

Mr. LANE. I think the burden of proof properly rests with the government when you have a criminal prosecution. But in a civil matter, common law and I am sure the bar, will lecture us in detail on what the common law is on this, but I mean the statements we have heard already today from the commissioners and from the IRS—it has always been the case that the person with the information should be able to document it.

We have a voluntary assessment system and the easiest and most effective way of auditing those tax returns is to go to the taxpayer who prepared them. Not to shift that burden to the backs of every other taxpayer in the country. We said in our testimony if we only represented tax evaders we would be wholeheartedly in support of this bill. But we represent millions of people out there who, every year, diligently keep track of their records and account for their income and expenses, and prepare tax returns and self-assess themselves.

To shift the burden on those poor people, the 82 or 83 percent of the population that complies, to be able to make cases against the 5, or 10, or 15 percent of the people that do not comply is really onerous. The cost to those people to maintain the records needed to answer all these IRS summonses would be just an outrage.

There is one other thing in my testimony that I did not cover. That is one of the changes that we would like to see included in this bill. Recently with respect to the 100-percent penalty or the trust fund recovery penalty, the Service for decades has maintained that there was a 3-year statute of limitations on the assessments for that penalty. They had 3 years from the presumptive date of filing of the employment tax returns from which that assessment arose, or that liability arose.

They recently have started to take the position that because Congress did not specify that section 6501(a) was the controlling statute of limitations on that 6672 assessment, that they had an open assessment and they had no rule they had to follow.

They have not done that for decades. They have taken the opposite position. We have always taken that position and I think we

should have it mandated, in law, that they will follow 6501(a) for purposes of making that trust fund recovery penalty assessment.

This is only just. I do not know where this ruse has come from lately, but it is an absurd position to take after they have taken this other opposite track for 30 years.

Mr. PORTMAN. Thank you, Madam Chairman.

Chairman JOHNSON. Thank you. Thank you for your testimony. It was really very helpful.

Mr. LANE. Thank you.

Chairman JOHNSON. I did not realize you had served in Connecticut, too.

Mr. LANE. Thank you.

Chairman JOHNSON. Let's start with Mr. Cohen.

STATEMENT OF N. JEROLD COHEN, CHAIR-ELECT, SECTION OF TAXATION, AMERICAN BAR ASSOCIATION

Mr. JEROLD COHEN. Thank you, Madam Chairman. The tax section, of course, has 25,000 members and it is the largest and broadest based group of tax lawyers in the country. I would like, on behalf of the section, as you begin your period of leadership of this subcommittee, to congratulate you and extend to you our commitment to work with this very important subcommittee in the improvement of the U.S. tax system.

We think that this subcommittee's oversight functions are often more important in improving the tax system than the enactment of specific legislation. And in that regard I would like to mention three items that are not contained in the legislative proposals and should not be. But that we would commend to the oversight subcommittee to watch.

The first is the Service's field service advice program. That is a program for advice between attorneys in the national office and the field concerning specific taxpayer audits.

Our concern is that the taxpayers have no input into the factual information coming back to the national office, no way to find out what has come out of that, and no ability to challenge positions being taken.

We are in a dialog with the IRS concerning that, but we do think it is something that the subcommittee should be aware of.

The next is third-party information access. A potentially very attractive source of information for the IRS, especially in cross-border transfer pricing cases, is access to information of third parties who have nothing to do with the audit that is under examination.

These taxpayers are merely in the same business and may even be competitors of the taxpayer under audit. Now, that information may be very important to the IRS but the inquiries, often with summonses, raise real questions of confidentiality, especially when you are after proprietary information from competitors.

That often also can impose a very strong burden of data collection on the third party. So we think this subcommittee should be aware of those inquiries by the Service.

And, finally, we too are concerned about the new user fees on installment agreements. Those fees really should have a limit on them as to the amount of tax involved, and the income of the per-

son seeking the installment agreement. Low-income taxpayers should not be subjected to those user fees.

Now, none of those do we think we need legislation on, but we do think they come within this subcommittee's purview. The comments we filed today on the bill of rights are very detailed on the H.R. 661 and I will not go over those.

I would like to mention two provisions only. Now, the first is section 903 concerning retroactive regulations. It would put further limitations on the Treasury in enacting regulations that have retroactive effective dates.

We think that the Treasury has been very responsive to the need to balance fairness with the need for uniformity and clarity of the tax laws. We are afraid that this would slow down the regulatory process and, thus, we do not support that provision.

The next provision on which I would like to comment is not one that we do not support. It is the 100-percent penalty provisions, section 701 through 703. We do support most of those, but we would like to suggest that there is a real problem that could be handled legislatively here.

That is the right of a taxpayer who has paid the 100-percent penalty, as a responsible officer, to seek contribution from others who are also responsible. That right is not available in many States. They do not afford it for a Federal penalty and we think that the taxpayer fairness requires that taxpayers who have paid that penalty be able to seek contributions from others who are equally responsible for it, and perhaps even more responsible for it.

Finally, Madam Chairman, I would like to mention another matter that is very closely related to taxpayer rights, and on which we are very concerned. And that is the proposal in H.R. 390 to shift the burden of proof.

We think that the current law shifts the burden of proof in the appropriate circumstances. It does shift the burden to the Government in the case, for example, of civil fraud, contrary to what I saw in Mr. Traficant's statement, it shifts it when new matters are raised by the commissioner before the tax court. But to shift it wholesale, we think, would place a tremendous burden on the Government, and it would result in very intrusive audits and would have severe financial consequences for the FISC.

So we believe this single change in the law would have a very significant and very adverse effect on our system.

Thank you, Madam Chairman, for allowing me to represent the section before you today.

[The prepared statement follows:]

TESTIMONY OF N. JEROLD COHEN
ON BEHALF OF THE AMERICAN BAR ASSOCIATION

SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

March 24, 1995

Madame Chairman and Members of the Subcommittee:

My name is N. Jerold Cohen. I am the Chair-Elect of the American Bar Association's Section of Taxation. The views I will express today are presented on behalf of the Section of Taxation. Unless otherwise noted, they have not been approved by the House of Delegates or the Board of Governors of the American Bar Association and, accordingly, should not be constructed as representing the position of the Association.

The Tax Section of the American Bar Association is comprised of approximately 25,000 tax lawyers located throughout the United States. As you begin your period of leadership of this very important Subcommittee, we extend to you our congratulations and our commitment to work with you, the other Members of the Subcommittee, and the Subcommittee staff in your efforts to further improve the U.S. tax system.

We appreciate the opportunity to appear before the Subcommittee today to comment on legislative interest in a second taxpayer bill of rights. Our comments are divided into three parts: first, I will offer some general comments on taxpayer rights legislation; second, I will comment on H.R. 661, the Taxpayer Bill of Rights 2, introduced in the House by Congressman Thornton; and, third, I will discuss a related matter of interest and concern to our members.

I. **Taxpayer Rights Legislation - General Comments**

Permit me to begin by reemphasizing the Tax Section's strong support for the ongoing work of the Oversight Subcommittee in monitoring the state of U.S. tax administration, including the effectiveness and efficiency of the Internal Revenue Service ("Service"). In our view, the Subcommittee's oversight activities often are more important in improving the functioning of the tax system than the enactment of specific legislation. Subcommittee hearings, such as today's, provide the American people an important forum for the discussion of perceived problems with tax administration and, thus, serve as a constructive mechanism for helping the Service properly carry out its mission.

We have a very strong interest as an organization of tax professionals in fostering a tax administration system that:

- applies the tax laws in a fair and evenhanded manner,
- aids taxpayers in fulfilling their obligations under the law,
- is sensitive to the impact that taxes and tax administration have on peoples' lives, and
- operates efficiently and effectively.

Notwithstanding our view that perhaps the greatest value of this Subcommittee's activities is its public oversight function, we recognize that there are issues of tax administration that cannot be solved merely by talk or administrative action but, rather, require a legislative

resolution. Occasionally, when we raise an administrative issue with the Service, we are told that restrictive legislation or a lack of legislative authority precludes the Service from correcting the problem. In such cases, we will bring the issue to the Subcommittee's attention, and, if appropriate, propose or support the Treasury Department's proposal of specific remedial legislation.

Inevitably there will be instances when we, as tax practitioners, and the Service or Treasury will disagree on a tax administration issue. There also may be legislative initiatives put before you that appear to be very popular with the public but which we believe, if enacted, would damage the tax system by seriously impeding the Service's ability to perform its tax administration obligations. In such cases, in spite of a proposal's public popularity, we will express our opposition.

One of the possible consequences of consideration of further taxpayer rights legislation is the danger that the Congress will attempt to micro-manage the Service. However, micro-management of the Internal Revenue Service by the Congress, in our opinion, is a mistake. As our country's "Board of Directors," the Congress plays a central role in making sure that the tax system is functioning satisfactorily. But as with any large organization, the day-to-day management of the Internal Revenue Service is best left to its officers and key employees.

As I indicated, we think that one of the values of a public discussion of taxpayer rights is the opportunity to identify issues that do not necessarily require a legislative response, but are of sufficient importance that the Subcommittee may wish to encourage a more in-depth analysis by the Service, the Treasury Department, the Subcommittee staff, the staff of the Joint Committee on Taxation or the General Accounting Office. There are four such areas that I would like to mention briefly today.

- **Field Service Advice** - The first matter involves what is known as "field service advice." During the past two years, the Service has adopted procedures governing communications between field and National Office personnel with respect to issues that arise in the audits of specific taxpayers. Although generally the Tax Section recognizes the importance of, and supports efforts to facilitate, interaction between Service field personnel and their lawyers in the National Office, the lack of any taxpayer involvement in the National Office's consideration of taxpayer-specific issues brought to its attention in the field service process and the lack of any ability to challenge positions taken by National Office personnel troubles us. We have expressed our concerns in a July 14, 1994, written submission to the Service, and we hope that the Service will take our comments and those of other interested organizations into account as these procedures are refined. Field service advice is a very sensitive area from the taxpayer's perspective, and it may merit future review by the Subcommittee.

- **Third-party information** - The second matter relates to the Internal Revenue

Service's access to so-called "third-party information." The Service apparently is of the view, perhaps properly, that it needs factual information in addition to that which it can obtain from the taxpayer under audit or from public sources in order to administer a system of arm's length transfer pricing. A potentially attractive source of additional information is third parties engaged in the same or a similar business to that of the taxpayer under audit. However, these third parties may have absolutely no relationship to the matter at issue and often are competitors of the taxpayer under examination. Under such circumstances, an inquiry from the Service into the third party's business affairs, using the Service's administrative summons authority, raises very important issues regarding the confidentiality of third-party information, particularly proprietary information. It also potentially imposes a significant data collection burden on the third party in connection with a matter with which it is not concerned. Because of the sensitivity of this audit technique, the Subcommittee might consider examining the relevant policy issues.

- **Advance rulings process** - A third area that may merit possible review by the Subcommittee is the Service's advance rulings process. Two developments relating to the Service's rulings program are of concern. First, the number of published revenue rulings, revenue procedures, and other advice of general applicability has gone down dramatically over the past 10-15 years.[1/] Second, access by individual taxpayers to advance rulings on specific transactions appears also to have decreased as the Service has expanded the number of areas in which it will not rule.

  Service rulings, both published rulings of general applicability and those that are taxpayer specific, are an important part of a properly functioning self-assessment system. If taxpayers are expected to file accurate returns that correctly apply the law, then the Internal Revenue Service must be given the resources - and it must devote those resources - to provide the necessary advance guidance. Otherwise, not only will taxpayers be frustrated by the lack of guidance, but we also are convinced that in some cases they will be reluctant to undertake desirable business transactions because of the uncertain tax results. In other instances, we fear that compliance levels will decrease.

[1/] This comment excludes an analysis of the issuance of regulations.

- **Installment Agreement User Fees** - On December 26, 1994, the Service issued proposed regulations (PS-39-94) that would impose user fees on taxpayers who enter into installment agreements for paying their tax liabilities. Under the proposed regulations, the fee for entering into a new installment agreement would be $43.00, and the fee for restructuring or reinstating an existing agreement would be $24.00.

  Although the dollar amounts of these user fees might appear minimal to most taxpayers, we are very concerned that they will impose a financial burden on low income taxpayers. We find it particularly troublesome that these fees could be imposed on low income taxpayers who by entering into payment agreements with the Service are attempting to meet their obligations to the Federal Government. Moreover, as a practical matter, requiring payment of a user fee for the privilege of entering into an installment agreement by persons with scarce resources will have the effect in many cases of merely reducing the amount of tax that the Service ultimately would receive. For these reasons, the Section recommends that the Subcommittee urge the Service to exempt low income taxpayers from the proposed installment agreement user fees. If the Subcommittee concludes that legislation is necessary to accomplish this objective, we would strongly support such legislation.

II. Taxpayer Bill of Rights 2 (H.R. 661)

Now, I would like to turn to the second part of our statement, which contains our specific comments on H.R. 661, the Taxpayer Bill of Rights 2.[2/] I will refer only to selected portions of the bill. A more detailed analysis has been provided to the Subcommittee staff.

A. Taxpayer Advocate

Section 101 of H.R. 661[3/] provides for the appointment of a senior Service official to be known as the Taxpayer Advocate, who would report directly to the Commissioner of Internal Revenue ("Commissioner").

Previously, our members opposed the provisions relating to the establishment of a Presidentially-appointed Taxpayer Advocate, for two principal reasons. First, they were concerned about the danger of improper influence within the Internal Revenue Service by a political appointee and second, they thought that, as a Service official, the Taxpayer Advocate should be accountable to the Commissioner. We are very pleased that H.R. 661 has abandoned the prior proposed

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[2/] The bill also has been introduced in the Senate by Senator Pryor as S. 258.

[3/] Unless otherwise indicated, section references are to H.R. 661.

structure and has made it clear that the Taxpayer Advocate will report to the Commissioner.[1/]

Notwithstanding the changes that have been made in Section 101, we continue to oppose its enactment. It would appear that the provision essentially codifies the present Service position of Taxpayer Ombudsman. In response to prior Congressional oversight activities relating to taxpayer service, the Service has put a taxpayer service management structure in place that seems to be working. If the Subcommittee has specific concerns about that structure, we suggest that these concerns be brought to the attention of the Commissioner and perhaps the Secretary. We do not think a legislatively-mandated management structure is desirable.

As more fully discussed below, we also oppose the provisions relating to Congressional reports and Taxpayer Service Orders.

- Congressional reports - We do not think that the Commissioner or the Treasury Department should be precluded from reviewing and commenting on the Taxpayer Advocate's reports prior to the time that they are transmitted to the Congress. A contemporary review and comment process should result in higher quality reports from the Taxpayer Advocate and more timely and complete commentaries from the Commissioner and Treasury.

- Taxpayer Assistance Orders - We think that it would be inappropriate to prevent the Commissioner from delegating to other senior Service officials the right to modify or rescind Taxpayer Assistance Orders issued by the Taxpayer Advocate. The Service is a very large organization and each year deals with millions of taxpayers in District and sub-District offices throughout the United States and in offices located in a number of foreign countries. It is impossible for the Commissioner to deal on a regular basis with matters involving individual taxpayers, in connection with Taxpayer Assistance Orders or otherwise. Furthermore, because the Commissioner is the Chief Executive Officer of the Internal Revenue Service, with responsibility for all of the management challenges facing the organization, such involvement clearly is not the best use of her time. She must be able to delegate authority to field personnel and should be empowered to do so in the Taxpayer Assistance Order context.

  We also wish to express our strong disagreement with the implication contained in Section 102 that a superior of the Commissioner (presumably the Secretary or Deputy Secretary of the Treasury or the President or Vice President of the United States) would have

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[1/] We also presume that the Taxpayer Advocate will be appointed by the Commissioner, although Section 101 does not so state.

the authority to become involved in taxpayer-specific matters pending before the Service. In the past, interference by people outside the Agency in matters involving specific taxpayers has created trouble in the tax system. We do not think it is advisable to alter the practice that the Commissioner's superiors have followed over the past 20 years of strictly avoiding any such involvement.

B. **Elimination of joint and several liability (American Bar Association recommendation)**

Under present law, married taxpayers are liable for their spouses' federal income taxes when they file joint returns. In community property jurisdictions, each spouse is liable for tax on one-half of the other spouse's earned income, even if they file separate returns. We recommend that for reasons of fairness and simplicity, both rules be repealed.

In many families today, both spouses work and follow separate business career paths. One spouse may have little or no direct knowledge of the business earnings and expenses of the other spouse. Even in the case of a family in which only one spouse works outside the home, that spouse may have little or no knowledge of the business affairs of the other spouse. Yet, in both situations, the spouse who did not earn the income can be liable for income taxes on the other spouse's income, even years after the couple has separated or divorced.

In most other developed countries, the trend is toward elimination or moderation of joint liability rules holding one spouse liable for the other's taxes. We think that the United States also should eliminate joint income tax liability and, therefore, we recommend that married persons be taxed only on their own individual income, without liability for tax on the income of their spouses, even when they file joint returns or reside in a community property jurisdiction.[5/]

C. **Designated Summons**

As a preface to our comments on the proposals relating to the designated summons procedure contained in Section 505, we wish to note our view that this relatively new procedure, which accords the Service an extraordinary audit tool, should continue to be considered by the Congress as in the experimental stage. We think its future will depend upon how the designated summons process is administered by the Service, and we encourage the Subcommittee to monitor this enforcement area.

Proposed Section 505 would require Regional Counsel to "review" the issuance of every designated summons. We oppose this requirement. Review by the Deputy Regional Counsel already is an administrative requirement, and we see no need to make such a requirement statutory. Such high level internal review has been effective in limiting multiple examinations of taxpayer books and records under Section

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[5/] In recognition of the sometimes harsh effects of joint liability, Congress enacted the "innocent spouse" provisions of Sections 6013(e) and 66. These rules are restrictive and ambiguous; they are among the most frequently litigated rules in the Internal Revenue Code. Repeal of joint liability would permit repeal of the innocent spouse provisions, resulting in a significant simplification of the tax system.

7605(b) without statutory specificity regarding the identity of the reviewer and should be just as effective in the case of a designated summons. Moreover, the existence of such a statutory requirement easily can lead to litigation regarding whether any "review" occurred in the particular case, and regarding what constitutes an adequate review.

The Service apparently believes that the use of a designated summons serves as an important method to obtain necessary information at the examination level. Under present law, however, the Service can use this method to extend the statute of limitations with respect to a taxpayer that has fully cooperated with the Service during the examination. Although this extraordinary compliance tool was designed to give the Service an additional means to deal with taxpayers who have resisted disclosure of necessary information, procedural fairness to all taxpayers is necessary to eliminate the potential for abuse outside this narrow context. Accordingly, the Subcommittee may wish to consider the following revisions to the statute to ensure the use of the designated summons as originally intended by Congress:

a. Provide that the taxpayer may, within 10 days of receiving a designated summons, file a petition in a District Court or the Tax Court seeking to quash or modify the summons, or seeking a court determination that the statute of limitations should not be suspended. In the event such an action is filed, the statute of limitations would remain suspended unless and until the court determined the existence of one or more of the following circumstances: (i) the Service had not previously requested in writing the information sought in the summons, (ii) the previous information request was not timely, or (iii) the person summoned did not have sufficient time to respond to the previous information request before the designated summons was issued. In order to quash or modify the summons, the taxpayer also would have to establish to the court's satisfaction that the person summoned had not failed to comply substantially with the previous information request. This right of judicial review would discourage the Service from issuing a designated summons in a case in which the taxpayer has cooperated in good faith during the examination and would allow an impartial court to decide whether the Service was attempting to misuse its designated summons authority.

b. Provide that the Service must identify the specific issue(s) and Code section(s) to which the designated summons relates, and that the statute of limitations may be suspended only with respect to the identified issue(s). This provision would ensure that the Service is using the designated summons to obtain only the information that it needs to develop a specific issue and would preserve the relevancy of the statute of limitations as an element of fairness in practical tax administration.

c. In lieu of the current requirement that the designated summons be issued at least 60 days before the date the statute of limitations is set to expire, provide that the designated summons must be issued at least 120 days before the date the statute of limitations is set to expire. This provision would protect the taxpayer against attempts by the Service

to extend the statute of limitations at the very last minute.

D. **100 Percent Penalty Provisions - Right of Contribution**

The American Bar Association previously has recommended legislation permitting a responsible person who has made payment of the 100 percent penalty to the Service to initiate a third-party action seeking contribution from the other responsible persons (Tax Section Recommendation 1981-6, 34 Tax Law. 1409 (1981)). We restate that recommendation today and, on behalf of the ABA, we strongly urge the Subcommittee to include a right of contribution in any legislation reported by the Subcommittee.

Too often the Service is satisfied with collecting the 100 percent penalty in the easiest situations. As a result, more culpable persons often escape liability. Unfortunately, state law does not always provide a remedy. Even states that permit joint tortfeasors to obtain contribution from one another do not permit a right of contribution in Section 6672 cases. These states believe that this is a federal matter and defer to the uniform rule in the Federal courts against contribution by other responsible persons.

The Federal rule against contribution is premised on the common law rule prohibiting wrongdoers from seeking contribution from one another. That common law rule has ceased to be the rule in many jurisdictions, and there is no reason to continue this rule in the case of a Section 6672 penalty. Moreover, we believe that the most effective way to assure that the Service will maximize its administrative collection efforts against all responsible persons is for each potentially liable person to know that contribution can be compelled. We would expect that, under these circumstances, more responsible persons will agree among themselves to contribute all that is necessary to satisfy the entire liability without the need for litigation.

We understand that there has been a reluctance to enact legislation granting a right of contribution because of the concern that it might lead to wealthier and more culpable people seeking contribution from less responsible persons. In our experience, it is more often true that the less responsible people suffer from the absence of a right of contribution. More importantly, however, if contribution were based on the culpability of a person regarding his or her control over the disbursement of available corporate funds, there would be no reason for any such person to be shielded from liability. However, additional protection might be provided by permitting someone in a contribution proceeding who is found not responsible to recover attorney's fees from the person(s) found responsible.

The Tax Section's 1981 Recommendation proposed granting the responsible party a right of contribution by cross-claim or third-party action in any litigation with the Internal Revenue Service regarding the 100 percent penalty, as well as the right to bring a third-party action against the other responsible persons in an independent judicial proceeding. The Association of the Bar of the City of New York Committee on Personal Income Tax also has proposed the enactment of a right of contribution ("New York City Bar Proposal"). The New York City Bar Proposal would require an action for contribution be brought in a separate lawsuit (rather than by cross-claim or third-party action in litigation with the Service) so that the Treasury's ability to collect the 100 percent penalty would not be obstructed by the action for

contribution. Although judicial economy might be fostered by having the contribution issue resolved in the same civil matter as the refund suit over the penalty, we think there is merit to avoiding any new procedure that might delay the Government's ability to obtain a judgment against the multiple responsible persons. Therefore, if the Subcommittee were to prefer the New York City Bar's recommendation of a separate proceeding, we would support that decision.

E. **Attorney's Fees**

The changes proposed in H.R. 661, in our opinion, are appropriate, and we support them. However, we think that there are other far more important changes that should be considered by the Subcommittee.

1. The Subcommittee should consider raising the ceilings on the net worth limitation and on the restriction of number of employees in order to make Section 7430 available to a broader range of individuals and small businesses.

2. The Subcommittee should consider whether taxpayers involved in declaratory judgment tax proceedings, as provided for in the Internal Revenue Code, should be eligible for awards.

3. The Subcommittee should consider whether any dollar limit on attorney's fees is necessary or appropriate. The law already requires that such fees must be reasonable. This reasonableness test could be amplified so as to be applied in light of prevailing levels of attorney's fees for work of similar nature in the geographical area in which the services are rendered. A fixed dollar limit on attorney's fees in any such proceeding also could be imposed.

F. **Retroactive Regulations**

The Tax Section urges the Subcommittee to reject the proposed amendment to Section 7805(b) contained in Section 903. The rules applicable to the effective dates of tax regulations should not be changed without a careful study of what the Service and Treasury have done in the past in establishing regulation effective dates, a determination of how the APA impacts on the promulgation of tax regulations generally, and a determination of the impact of any change on the administration of the law. We believe that a provision similar to Section 903 cannot be justified at least without a clear showing that the abusive cases of retroactivity, if any, are the norm rather than the exception.

In our view, a blanket restriction on retroactivity is unwarranted. Given the limited available resources, the Service and Treasury need a reasonable period of time to issue regulations. If regulations are timely issued, they should apply to all taxpayers similarly situated. If there are abuses resulting from the use of retroactive effective dates, it may be preferable to limit the period of time following enactment during which the Treasury could promulgate a retroactive regulation. Certainly the Congress has the ability to take such action on a case-by-case basis

as part of the consideration of specific pieces of proposed tax legislation.

Just as both Houses of Congress have recognized the unique status of tax regulations in the current consideration of proposals relating to a regulatory moratorium and changes in the regulatory process, we think the Subcommittee must consider very carefully any proposed change in Section 7805(b).

III. **Proposed Shift in Burden of Proof (H.R. 390)**

Finally, I would like to discuss another matter that we think is of extreme importance to future tax administration, namely, the proposal in H.R. 390 to shift the burden of proof in tax cases.

H.R. 390, 104th Cong., 1st Sess. (1995), would amend the Internal Revenue Code to place the burden of proof on the Secretary of the Treasury in all court proceedings involving tax matters.

The general allocation of the burden of proof to the taxpayer is consistent with our self-assessment system of tax administration, which relies on the taxpayer to maintain the necessary records to report accurately his or her income and expenses on a tax return at the end of the year. Accurate records, of course, are critical to resolving tax controversies, whether during the audit and administrative appeals processes before the Internal Revenue Service or in the courts. Because the taxpayer generates and is responsible for maintaining his or her business and other tax records, the taxpayer is in the best position to prove the amount of his or her income. Thus, the allocation of the burden of proof to the taxpayer ensures that taxpayers maintain accurate records and promotes the efficient administration of the tax system and the resolution of tax controversies.

Placing the burden of proof on the Government in tax litigation would require the Government to produce the business records, testimony or other evidence necessary to demonstrate the taxpayer's tax liability. This would place the Government at a fundamental disadvantage and likely would have three distinct effects on tax administration: (1) taxpayers might be inclined to be less forthright in preparing and filing their tax returns and may take more aggressive positions on their returns; (2) the Service would be forced to use its administrative summons power more frequently and intrusively during the audit process to gather the necessary information to support its determinations; more taxpayers would litigate the Service's audit determinations.

The potential consequences of these effects on tax administration could be very dramatic. We would expect that the Internal Revenue Service no longer would be able to assure general compliance with the tax laws, the high level of tax compliance in the United States would decrease -- perhaps substantially -- and the revenues collected by the Federal Government from income and other taxes likely would correspondingly decrease, perhaps substantially. In a nutshell, this single change in the law could further significantly complicate the fiscal condition of the United States.

Madame Chairman, permit me to thank you again for including the Tax Section in this important Subcommittee hearing. This concludes my prepared remarks. I would be pleased to answer any questions.

Chairman JOHNSON. Thank you and thank you for your testimony.

Ms. Walker, chair of the Tax Executive Committee at the American Institute of Certified Public Accountants, would you begin?

STATEMENT OF DEBORAH WALKER, CHAIR, TAX EXECUTIVE COMMITTEE, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Ms. WALKER. Thank you, Madam Chairman, for the opportunity to offer recommendations for improving the Federal tax administration process.

I am Deborah Walker, chair of the Tax Executive Committee of the American Institute of Certified Public Accountants. We have 320,000 members. And it is our national professional organization of CPAs.

Let me just summarize some of this in view of the late hour and what we have heard prior to this.

Turning to the taxpayer ombudsmen issues, we see no need to disturb the reporting structure and risk hindering their ability to function effectively within the district. In fact, we think the quality of service provided by this group ranks among the highest in the Internal Revenue Service.

There are two things that we think would significantly help and I know we have heard a lot of concerns about that today. But we think that perhaps the biggest issue is training.

Too often training gets written out of the budget either in the budget process here or when it gets down to the IRS.

And resources that should go to training, resources that could help some of the issues that end up in problem resolution, could help with IRS agents more adequately trained in procedures and the basics of tax law.

The other important thing is that the Taxpayer Ombudsman should report to Congress on a periodic basis the activities of their office, the problem resolution office and the ombudsmen office. Also a response from the IRS on those activities is important. The response could detail what has been done to correct the problems noted. That may get away from the micromanagement that Congress needs to avoid.

Let me turn now to interest. We believe that the statute should be changed to provide that the Secretary must abate interest or refund interest attributable to unreasonable IRS errors and delays. The problem is, as we define it, that the ministerial act limitation is subject to interpretation and is interpreted far too narrowly.

We are concerned, by adding a managerial standard, that we are really just compounding the problem we already have which is we cannot define what a ministerial act is or a managerial standard. And it should basically be, if it is an IRS error or delay, that interest should be abated.

The last issue there is that interest may be abated. Of course, that has been interpreted to does not have to be abated. And therefore, we think that the may should changed to must be abated.

We also believe that there should be a reasonable extension of the 10-day interest free period to a 21-day period. However, we do

not support any dollar limitations with respect to that increased interest-free period.

Another piece of the interest problem is the differential between the interest rate owed to taxpayers on overpayments and the interest rate owed to the government. Congress included specific guidance for the Secretary to implement comprehensive crediting procedures. And those procedures have not been implemented. They are no longer on the business plan for 1995.

We think they need to be on that business plan and there needs to be some guidance for the crediting procedures.

Finally, we think that notwithstanding that we can make a lot of money checking IRS computations, we believe that interest computations should be disclosed to the taxpayers, the rates that are used, the dates that the rates apply, and when the payments and credits were made to various accounts.

Without that information it is virtually impossible for a taxpayer to determine whether the interest charges are correct, and it seems that certainly where interest charges are more than a diminimus amount of say, $50 or $100, it would not be too difficult to simply print the calculations out and supply them to the taxpayer so that they can check the calculations and the facts that were used in generating the calculations.

Turning to the examination procedures, we believe that stronger legislation is needed to ensure that the taxpayer is notified of his rights and allowed to representation. We have far too many instances where the IRS implies to the taxpayers that they must appear personally before the Internal Revenue Service and that a preparer cannot represent them or that they are not aware that a taxpayer can represent them.

So, we think it is important that when there is an examination, taxpayers be notified in writing. It is important that they be aware of the fact that they could be represented for this.

And finally, let me turn to the burden of proof issues. The AICPA cannot support the broad proposal contained in H.R. 390 which shifts the burden of proof to the government in any court proceeding.

With a voluntary tax system there is absolutely no way that the people who are signing under penalties of perjury should not have the burden of proof for supporting the numbers they are signing to. With that provision enacted, the IRS will have a very hard time, and as practitioners we will have a very hard time advising our clients.

The way that I look at it, and perhaps I have not thought long enough about it, but it seems to me that in almost every case you could simply get to court and tie things up forever, which is not going to be a good use of anybody's resources.

Having made that broad statement I do need to point out that there are certain instances, some of which Jerry mentioned—fraud—where the burden of proof should be on the government. And one area that we think is very important is information returns. The burden of proof should be on the government. The IRS needs to search information returns before they impose the burden on the taxpayers, since information returns are prepared by somebody else.

With that, let me close and say as the AICPA we are pleased to be able to help you and work toward the same thing that everyone wants, which is an efficient and effective tax administration system.

Thank you.

[The prepared statement follows:]

TESTIMONY OF DEBORAH WALKER
AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

Thank you, Madame Chairman, for the opportunity to offer recommendations for improving the federal tax administration process. I am Deborah Walker, Chair of the Tax Executive Committee of the American Institute of Certified Public Accountants (AICPA). The AICPA is the national professional organization of CPAs, with over 320,000 members. Many of our members are tax practitioners who are highly concerned with the Internal Revenue Service's standards of accuracy, timeliness, fairness, and consistency and how those standards are applied to taxpayers and practitioners. We also recognize the need for the IRS to administer the system on an efficient and effective basis. It is imperative, therefore, that any changes balance those sometimes competing needs.

ADMINISTRATION IMPROVEMENTS

1. The Taxpayer Ombudsman and Problem Resolution Officers

We believe that the Taxpayer Ombudsman and the Problem Resolution Officers (PRO) have done an outstanding job. The quality of service provided by this group ranks among the highest in the Internal Revenue Service. We see no need to disturb the PRO's reporting structure and risk hindering their ability to function effectively within their District by placing them in a position as "outsiders" to other District personnel. There are definite advantages to having the source of problem identification and correction *within* the IRS.

The Taxpayer Ombudsman and the Problem Resolution Officers are more effective because of their ability to investigate the problems, analyze the reasons for them, report them to the appropriate executives, and monitor solutions. The Taxpayer Ombudsman has brought to the Commissioner's attention identified problems and legislative corrections. We believe that there exists an opportunity to enhance the program by:

- Statutory protection of training funds,
- Adequate funding of the Internal Revenue Service,
- Expansion of statutory authority under section 7811,
- Elevation of the Taxpayer Ombudsman position, and
- Statutory provision for an administrative appeal of Collection Division's actions within the IRS.

Many of the current problems of the IRS stem first from an excessive workload in the Collection Division and insufficient training of personnel in the realities of the business world. Additionally, the lack of emphasis on maintaining a current workload in the Examination Division has resulted in unnecessary hardships for those taxpayers who become involved in disagreements with the IRS.

We have consistently emphasized, in our prior testimony to the Congress, the need for improvement in the personnel recruiting and training programs of the IRS. IRS training programs are sometimes inadequately funded when resources are needed to maintain other programs. It is our belief, based on considerable experience, that many of the problems brought to the PROs are a result of IRS employees who are inadequately trained in IRS procedures and the basics of the tax law.

Further, we believe that the Taxpayer Ombudsman position should be elevated within the IRS organization. In order to accomplish this, we believe the Taxpayer Ombudsman must be a peer of the Deputy Commissioner or Chief Counsel.

We believe that the Problems Resolution Program operation would be strengthened by establishing a plan whereby the Taxpayer Ombudsman reports to the Congress on a periodic basis regarding:

- initiatives that the Taxpayer Ombudsman's office has taken,
- recommendations flowing in from the field,
- the inventory of open items on which no action has been taken,
- the inventory of items on which changes have been made and whether or not those changes resolve the underlying problem,

- recommended changes that have not been implemented with the reasons for not doing so, and the IRS official who made the final decision on each recommended change,
- Taxpayer Assistance Orders which were not honored by the IRS in a timely manner, and
- recommended legislative changes to mitigate problems taxpayers incur in dealing with the IRS.

We recommend that periodic reports be submitted directly to the Congress, without the perceived undue influence regarding prior review or comment from the Commissioner, the Secretary of the Treasury, any other officer or employee of the Department of the Treasury, or the Office of Management and Budget. Additionally, we recommend a formal response to all of the Taxpayer Ombudsman's recommendations be submitted to the Congress by the Commissioner.

Further, we believe that expansion of the Taxpayer Ombudsman's statutory authority under section 7811 is essential to maintaining an efficient tax administration. Section 7811 authorizes the Taxpayer Ombudsman to issue a Taxpayer Assistance Order if the Taxpayer Ombudsman determines the taxpayer is suffering or about to suffer a significant hardship. Taxpayer Assistance Orders require certain actions such as the release of taxpayer property levied upon by the IRS, and may require the IRS to cease any action, or refrain from taking any action as a result of the manner in which the internal revenue laws are being administered. The Code, regulations and other administrative guidance set forth a standard of hardship requiring that the basis for seeking relief is "undue" or "significant" hardship. Therefore, we recommend the elimination of the qualifiers "undue", "significant", etc. thereby providing broader authority for the Taxpayer Ombudsman to take action so taxpayers do not unfairly suffer.

2. Awarding of Costs and Certain Fees

Under current law, as set forth in section 7430, administrative costs may be recovered from the IRS only if incurred on or after the earlier of (1) receipt of the final decision of Appeals or (2) receipt of the statutory notice of deficiency. However, generally no administrative costs are incurred after this period and thus, section 7430 is not effectively carrying out the intent of Congress. Further, the taxpayer is required to demonstrate that the IRS position was not "substantially justified."

We support legislation which would amend section 7430 to provide that any person who substantially prevails in an administrative proceeding can recover reasonable administrative costs if such costs are incurred after the earlier of (1) the date of the first notice of proposed deficiency that allows the person an opportunity for administrative review with Appeals or (2) the date of the notice of deficiency described in section 6212. To protect the government, the amendment to section 7430 could provide that administrative costs will not be recovered if the government can show that its position was substantially justified.

3. Notification of Intention to Offset

We believe the IRS should provide taxpayers with notification of its intention to offset a balance due on one account or module with a refund on another. We recognize the IRS's authority to credit amounts due the taxpayer to any other liability of the taxpayer in accordance with IRC section 6402. However, in such cases, the taxpayer is not notified of such credit application until after the action is taken. In many instances, the balance due is erroneously assessed or subsequently abated. Also, the credit application may have serious ramifications for the taxpayer, particularly an individual or a smaller business that cannot afford to engage a representative to deal with the IRS on such issues.

For example, a taxpayer may elect to apply an overpayment of income tax from one year to the next as an estimated tax payment. This overpayment is sufficient to cover the taxpayer's first quarter estimate for the subsequent year. The taxpayer, a sole proprietor, may have been assessed an employment tax penalty on a given quarter. The penalty is due to the fact that a proper liability breakdown was not included with the Form 941. Once this information is supplied by the taxpayer, the penalty will be abated.

Under the IRS's current system, the taxpayer's overpayment of income tax will be applied to the outstanding employment tax assessment. The amount applied to the first quarter of the subsequent tax year as an estimated tax payment may be insufficient to cover the liability and the taxpayer is subject to an estimated tax penalty on the subsequent year. If the employment tax penalty is subsequently abated, the amount credited against such assessment will be refunded to the taxpayer from the employment tax account. However, the estimated tax penalty will not be abated automatically.

The taxpayer should be notified prior to the application of overpayments to other balances of such taxpayer. There may be other actions in progress to rectify such accounts or significant mitigating factors under consideration by another area within the IRS. The application of such overpayments, without providing the taxpayer an opportunity to address the situation, is a denial of "due process" and may create unnecessary complications and frustrations for both the IRS and taxpayers.

4. Protection from Retroactivity — Prospective Effective Dates for Treasury Regulations

We urge the Subcommittee to consider legislation that would provide protection for taxpayers who make "good faith" efforts to comply with the tax laws during the period between enactment of the law and issuance of clear guidelines and final regulations. The AICPA supports the qualifications for protection from retroactivity as set forth in S. 258, *Taxpayer Bill of Rights 2*, introduced January 23, 1995. Such reforms would recognize taxpayers' needs for early guidance in complex areas of the tax law, while at the same time stimulate the IRS and the Treasury to accelerate issuance of such guidance.

5. Rounding

The AICPA believes requiring the rounding of numbers on most tax returns would decrease the number of errors in tax return preparation and administration. It could greatly enhance efficiency in processing tax returns and does not affect the rights of individual taxpayers. We strongly encourage the Congress to pass legislation requiring the rounding of numbers on most tax returns.

6. Disclosure Changes

IRS statistics indicate approximately 50 percent of all returns are prepared by commercial preparers. We believe, especially because of the complex nature of the law, that taxpayers have a right to expect that the hiring of a preparer will avoid personal inconvenience and unnecessary loss of their own productive time in having their return accepted in the processing phases by the IRS. Our experience and IRS records show the processing of notices during the return perfection and processing phase is a significant workload factor. Many practitioners and taxpayers, unaware of the strict enforcement of the disclosure rules, attempt to resolve these notices by having the preparer "do what the preparer is being paid to do" — prepare the return, solve compliance problems, and appropriately interface with the Service.

We believe changes in the disclosure rules would reduce taxpayer burden, reduce IRS correspondence in dealing with abortive contacts by preparers without a power of attorney, and support the taxpayer's right to be represented. Specifically, we suggest section 6103 be amended to allow for taxpayer representatives to request and receive a taxpayer identification number on the telephone without a power of attorney being filed and to allow IRS personnel to contact a preparer who has signed the return, or accept contacts by such a preparer on behalf of the taxpayer who has received a notice from the IRS with respect to that return. This would reduce the cost of tax administration for the IRS, taxpayers, and preparers. Such communications would be allowed solely for the purpose of perfecting or processing the return for a limited period (e.g., twelve or eighteen months) after the due date of the return or the date the return is filed.

INTEREST

7. Abatement of Interest for Unreasonable IRS Delays

Section 6404(e)(1) provides "...the Secretary *may* (emphasis added) abate" interest on "any deficiency in whole or in part to [due to] any error or delay by an officer or employee of the IRS (acting in his official capacity) in performing a ministerial act."

The ministerial act requirement too narrowly limits the possibility of relief to the taxpayer with the result that the IRS will not abate interest even if it is the IRS's fault. To add a managerial standard only further complicates the statute by providing another unclear standard for interest abatement. Further, IRS rejection of a taxpayer request to abate interest is consistently denied by the courts because section 6404(e)(1) provides no requirement for abatement.

We believe that the statute must be changed to provide that the Secretary must abate or refund interest attributable to unreasonable IRS errors and delays. The ministerial act limitation should be deleted from the statute, and courts should use "unreasonable error or delay" as the appropriate standard of review.

8. Netting of Overpayments and Underpayments for the Calculation of Interest

In 1986, Congress enacted a differential between the interest owed to taxpayers on overpayments and the interest owed to the government on underpayments. Recognizing the inequity created, Congress included specific guidance that "the Secretary should implement the most comprehensive crediting procedures under section 6402 that are consistent with sound administrative practice..." However, the IRS has not responded to Congress's guidance which appeared in the legislative history to the 1986 Tax Reform Act, the 1990 Omnibus Budget Reconciliation Act, and the 1994 General Agreement on Tariffs and Trade. Consequently, we urge Congress to pass legislation requiring "comprehensive crediting procedures under section 6402."

9. Extension of Interest-Free Period for Payment of Tax After Notice and Demand

Taxpayers generally must pay interest on late payments of tax. However, a ten day interest-free period is provided for taxpayers who pay the tax due within ten days of the date of the notice and demand for payment. Oftentimes, the taxpayer does not even receive the notice and demand until after the ten days have expired. Even if the taxpayer received the notice and demand on the date of the notice, ten days often is not adequate time for the taxpayer to gather data for a response, mail a response, and for the IRS to receive it, open it, and route it to the correct area. Therefore, we believe a reasonable extension of the ten day interest-free period to a twenty-one day period should be legislated. We do not support any dollar limitations on this increased interest-free period as is currently proposed in S. 258, *Taxpayer Bill of Rights 2*.

10. Detailed Interest Computations

We believe the IRS should provide interest computations, as a matter of course, to taxpayers when adjustments involving interest are made. Currently the taxpayer only receives a notice showing the amount of tax and the interest due on such amount. IRC section 7522, which is applicable for notices mailed on or after January 1, 1990, requires that such notices describe the "basis for, and identify the amounts (if any) of, the tax due, interest, additional amounts, additions to the tax, and assessable penalties included in such notice." At the present time, the starting date for the interest, the principal amount upon which such interest is based and the rate charged on such amount are not provided to the taxpayer as a part of the notice procedure.

We believe the " basis for" description in the notice should apply to interest computations and should include interest rates and the dates for which the interest applied, the dates and amounts of payments and credits and the interest compounding method. With this information, taxpayers and practitioners

will be able to verify the accuracy of interest computations and expeditiously resolve any discrepancies. We recognize that detailed interest computations could result in a burden to the IRS. Therefore, an exception could be made for de minimis interest amounts such as $50 or $100.

COLLECTION IMPROVEMENTS

11. Application for Extension of Time to Pay (Form 2911) and Installment Agreements

The IRS's Consolidated Penalty Handbook stresses that the purpose of penalties is to "encourage compliant conduct." We support legislative and administrative efforts that the IRS no longer assert the failure to pay penalty when an installment agreement is in effect. We suggest the following expansion of the Taxpayer Ombudsman's recommendation:

> When there has been an application for extension of time to pay or a request for an installment agreement which is made in good faith, in proper form, and evidences a reasonable basis for the application, then the penalty should not be applied, beginning on the date of said application until denial or the termination of the extension or installment agreement, whichever occurs later.

12. Taxpayer Rights Review — Administrative Appeal of Collection Actions

We recommend the creation of an administrative appeal of collection actions (including liens, levies, installment agreements and seizure actions) to resolve issues on matters not related to the determination of tax. This procedure could be an additional function of the Appeals Division and should apply to actions where the deficiency was assessed without the taxpayer's actual knowledge or without an opportunity for an administrative appeal.

13. Expansion of Authority to Release Liens

The IRS currently may only withdraw a filed notice of lien if the notice was erroneously filed or if the lien has been paid, bonded, or became unenforceable. In many instances, taxpayers suffer severe hardships when a lien is filed against them. It is especially difficult for small business owners to carry on business because creditors are unwilling to do business with the taxpayer because of the IRS lien. We recommend expansion of the Secretary's authority to issue a certificate of release of lien and expansion of the IRS's authority to return levied property to a taxpayer when the taxpayer has overpaid their liability if it is determined that:

- filing of the notice was premature or not in accordance with IRS administrative procedures,
- the taxpayer has entered into an installment agreement to satisfy the tax liability,
- withdrawal of the lien will facilitate collection of the liability, or
- withdrawal of the lien would be in the best interests of the taxpayer and the Government.

Further, at the taxpayer's request, the IRS should be required to make reasonable efforts to give notice of the release of lien to the taxpayer's creditors and to credit reporting agencies.

14. Increase Levy Exemption Amount

We support legislation to increase the exemption amounts for property exempt from levy and the indexing of that amount for inflation. In addition, the exemptions permitted to an employee whose salary is levied upon by the IRS should include premiums on health benefits, life, or disability insurance. Thus, a wage earner would be protected from losing his or her health benefits coverage as a result of the IRS's levy. Also, there appears to be an inequity in the statute in that the statutory exemptions do not apply to wages which are direct deposited into a bank account.

15. Damages for Wrongful Liens

We support legislation for a cause of action against the IRS for wrongful liens. Additionally, we would like to have included a similar cause of action on liens in violation of the automatic stay provisions in bankruptcy proceedings.

16. Offers-in-Compromise

We support legislation which would eliminate the requirement of an opinion of Counsel in an instance where taxes are being compromised based upon doubt as to collectibility. Absent this change, we support legislation for a significant increase in the amount requiring a written opinion of Counsel for an offer-in-compromise.

17. Information Return Reporting

Where the taxpayer asserts a nonfrivolous dispute with respect to any item of income reported to the IRS on an information return, then the IRS — not the taxpayer — should bear the burden of proof in any deficiency or refund proceeding absent a showing that the IRS conducted a reasonable investigation of the facts and physically examined the taxpayer's return.

18. Payroll Tax Collection

The procedure for assessment against and collection of unpaid payroll taxes from the owners, officers, directors and/or anyone with the authority and control over payroll funds, "responsible party," helps ensure that "trust" funds are paid when due. However, the "fairness" of collecting all the tax from only one party when many may be involved is questionable. The statute actually permits the IRS to collect the full amount from each party; however, the administration has stated that it does not collect more than the actual liability. Because no party is allowed to know what has been assessed and collected from each of the other responsible parties and how any payment was applied, procedures should be established to show how, and from whom, the IRS has collected the tax and whether civil recovery from others is possible in a post-collection context.

Since collection efforts are directed against the person residing in the area of the IRS office assigned the case rather than against the person most liable for the failure to pay the taxes, or the person who actually benefitted from the failure to pay the taxes, such efforts are often unfair. We urge you to consider changes in this section of the law that would require an equal and fair pursuit of collection from all parties involved. We believe the law should require the IRS to disclose the "uncollected balance" (by tax period) remaining on the assessment to any party from whom it is attempting collection, as well as the identities of other parties against whom the assessment is made or to be made.

Further, we support a requirement that the IRS issue a preliminary notice which will give the taxpayer the right to an administrative appeals hearing for the failure to collect and pay trust fund taxes, or attempt to evade or defeat such taxes provided in section 6672. Also, we support legislative efforts to prevent the IRS from collecting more than 100% of the trust fund taxes owed. We believe legislation should be enacted to prohibit the IRS from attempting to collect the 100% penalty from any alleged responsible persons during the pendency of any administrative proceeding or judicial action brought to contest the merits of a 100% penalty liability.

19. Safeguard for Divorced or Separated Spouses and Married Persons in Community Property States

We believe additional reforms are needed to ensure the equal and fair treatment of spouses who are separated, divorced and/or have community property issues compounding their tax problems. We are especially concerned with the collection procedures applicable in these situations. Often, a

divorced spouse is not aware that a liability has been created in an examination process where the other party was the party examined, as in a situation where one taxpayer has a Schedule C, *Profit or Loss from Business (Sole Proprietor)*. Yet, after the assessment is made, the IRS will attempt to collect the tax from either party. If the taxpayers are divorced or separated and now live in different regions, or even different districts, the IRS tends to only make collection efforts against the spouse living in the area of the IRS office assigned the collection case, even though the distant spouse may have more funds available to pay the bill (and maybe even be the source of the liability).

The root of this problem is in the examination procedures that do not require both spouses to be involved in an audit. We support legislative procedures that require, at the initiation of an examination, the absent spouse to acknowledge by signature whether the other spouse may, or may not, represent the absent spouse. If both parties are aware of, or participate in, the examination, then no one should be caught unaware of the liability and the resulting collection process. Additionally, legislation may be required to ensure that disclosure laws are changed to provide adequate information to the divorced spouse in community property states.

EXAMINATION IMPROVEMENTS

20. Taxpayer Interviews

Section 7521 specifically states that "if the taxpayer clearly states to an officer or employee of the IRS at any time during any interview ...that the taxpayer wishes to consult with an attorney, certified public accountant, enrolled agent, enrolled actuary, ...such officer or employee shall suspend such interview regardless of whether the taxpayer may have answered one or more questions." The AICPA is aware of many instances where the IRS appeared to demand that a taxpayer personally appear alone at the initial examination meeting and the taxpayer was not informed of the right to have a representative appear on his or her behalf. In most instances, an examination can be completely handled by a representative and we believe stronger legislation is needed to ensure the taxpayer is notified of his or her rights and allowed that representation.

21. Place of Examination

We believe that section 7605(a) should be amended to say that the "time and place of examination...shall be such time and place as requested by the taxpayer and as are reasonable under the circumstances." Currently, section 7605(a) provides that the "time and place of examination...shall be such time and place as may be fixed by the Secretary and as are reasonable under the circumstances." Treasury Reg. section 301.7605-1 provides general criteria for the IRS to apply in determining whether a particular time and place for an examination are reasonable under the circumstances. The regulation also instructs that sound judgment should be exercised in applying these criteria and that there should be a balancing of convenience of the taxpayer with the requirements of sound and efficient tax administration. Unfortunately, the IRS placed unnecessary limitations on field personnel by instituting IRM 4235, section 320(1) and (2).

This IRM guidance provides that the place of examination will be established consistent with the regulation and with few exceptions, the examination of the records should be made at the taxpayer's place of business. Also, this guidance indicates that consideration should be given to conducting the examination at the IRS office or the representative's office only if the taxpayer's place of business falls short in some respect relevant to conducting an examination. These guidelines are inadequate and should, therefore, be clarified legislatively.

22. Notice of Examination

The Internal Revenue Service initially contacts taxpayers either by telephone or letter to inform them of an upcoming examination. When the initial contact is made by telephone, it is followed up by letter in order to present the taxpayers' rights in written form. However, the process of allowing initial contacts to be made by telephone creates many problems in assuring taxpayers of their rights. The

revenue agent, however, may request an appointment with the taxpayer in that initial call. Sometimes the taxpayer believes that he or she must personally be at the appointment and the taxpayer does not understand that they have a right to representation.

In order to protect the rights of the taxpayer, the AICPA believes that section 7605 should be amended to require that the initial notification of an examination be made in writing. This requirement should be for all examinations. When the taxpayer receives a notice of examination, the rights accorded a taxpayer under section 7521 (explanation of examination process, right to be represented by an attorney, certified public accountant, etc.) shall attach at that time.

CONCLUSION

In conclusion, the AICPA wants to again thank you for the opportunity to present our comments and recommendations for more efficient administration of the tax system and improvements to the rights of the taxpayer. We will be glad to assist you or your staff with any questions or concerns.

Chairman JOHNSON. Thank you.

Mr. Keating, the executive vice president of the National Taxpayers Union, with Mr. Jack Wade.

STATEMENT OF DAVID KEATING, EXECUTIVE VICE PRESIDENT, NATIONAL TAXPAYERS UNION; ACCOMPANIED BY JACK WADE, CONSULTANT, NATIONAL TAXPAYERS UNION

Mr. KEATING. Thank you, Madam Chairman, for inviting us to testify. I am David Keating, executive vice president of the National Taxpayers Union, and with me is Jack Wade, who is an expert on taxpayer's rights issues. He once headed the revenue officer training program for the IRS and he can tell you that much needs to be done to protect taxpayer's rights.

We especially appreciate your scheduling this hearing today and your interest in these issues. We strongly endorse S. 258. We think it can be improved to better protect taxpayer's rights. At the outset I would like to note that the bill that passed in 1992, proposed establishing the office of the taxpayer advocate. That legislation proposed making that position a political appointment.

That is not in S. 258, and we think it should be. We think a political appointee would come to the job independent of the restrictive mission oriented mentality of just collecting taxes, and not providing service to taxpayers.

We believe it would be a very, very refreshing change from business as usual. There are too many problems that have literally festered for over a decade. Look at the many problems that were identified by the Administrative Conference of the U.S. two decades ago and nothing ever gets done about it.

We think a political appointee in this post will finally give the IRS a true taxpayer advocate who can get some of these problems settled.

The standard for issuing a taxpayer assistance order is much too high. The fact that a taxpayer has to be burdened by a significant hardship is unfair. The taxpayer advocate should be able to act in other situations. My written statement suggests some commonsense situations where the taxpayer advocate should be empowered to act.

One other issue that I would like to address is the provision that allows a taxpayer to sue for damages. We think the standard of proof there is too high. The original bill in 1988 would have allowed taxpayers to recover when the IRS was careless. During the 1980s we had all kinds of increased regulations on tax preparers and on taxpayers, requiring due diligence in the preparing of tax returns.

Why cannot we have a due diligence standard on the IRS? We think that is entirely reasonable. If the taxpayers have to exercise due diligence, then why not the IRS?

Attorney fee awards—it is great to have them, but let's face it, you cannot hire a tax attorney for $75 an hour, virtually anywhere in this country.

We think it is time to raise this cap. The bill proposes a $110 cap. That was in the bill that was passed in 1992. At the very least let us index that $110 for inflation since 1992. A $150 per hour cap would be more reasonable.

I would also like to concur fully with Ms. Walker's statements on interest, computations, and taxpayer representation issues. We agree with that 100 percent.

Another provision in S. 258 would create a 1-year pilot program for appeals of enforcement actions in collections to the appeals division.

We think this is a very, very interesting idea and we hope that this will be made permanent if this bill becomes law. There are many taxpayers who have very modest means. They get caught in these collection actions, they cannot afford to hire representation, they cannot hire an accountant, they cannot hire a tax preparer, they cannot hire an enrolled agent.

If they could at least go to some appeals division in addition to the taxpayer advocate, maybe some of these problems could be corrected.

We also think it is time to selectively modify the Declaratory Relief Act and the Anti-Injunction Act, because there are just too many barriers to taxpayers who are trying to enforce their rights.

Our statement gives some very limited examples of how these laws can be changed to improve taxpayer's rights.

It is also very important to safeguard the right to be self-supporting. The tax laws require a businessperson to keep just $1,100 of business equipment. This is ridiculous. The Foodstamp Program allows more than that. You can qualify for foodstamps with more assets than the IRS will allow you to keep.

It is time to raise these limits. There are many taxpayers who will declare bankruptcy simply to try to keep enough to produce income to pay their taxes. We think this would take some load off the bankruptcy courts, help the IRS, and safeguard the right to be self-supporting, which we think is very important.

The burden of proof can and should be shifted in some cases. Particularly for the 100-percent penalty on trust fund taxes.

We have seen many, many nonresponsible people get hit with this penalty and it is simply unfair for the IRS to come after a bookkeeper and people who are just acting at direction of their bosses.

We also have seen instances where this penalty gets collected more than once, even though it is not supposed to be collected more than once. There is nothing in the law that prevents it from being collected more than once.

There is a big problem on this issue of innocent spouses and I am very glad to hear that Professor Beck testified earlier. We think this reform is very important.

Almost everybody in the agency who works on the front line knows this is a problem and it just does not get fixed. We have heard reports of tax practitioners who cannot even get a power of attorney honored by the IRS in representing a divorced female spouse. They do not even get notified of what is going on.

So clearly something needs to be done in this area and we think Professor Beck's recommendations are very much on target.

I would like to say one last thing. The ultimate improvement to enforcing and helping taxpayer's rights would be to simplify the tax code. We are thrilled to hear that Congressman Archer will hold hearings on the issue of a greatly simplified tax code. The abuses and the problems come from a tax law that is so complicated that no one can understand it.

Thank you, Madam Chairman.

[The prepared statement follows:]

Statement of

David Keating
Executive Vice President
National Taxpayers Union

before the

Subcommittee On Oversight
Committee On Ways & Means
U.S. House of Representatives

on

Taxpayers' Rights Issues

March 24, 1995

Thank you for the opportunity to testify on reforms to improve taxpayer rights. I represent the 300,000 members of the National Taxpayers Union who strongly support providing taxpayers with additional rights and protections during the tax audit and collection process. I am accompanied by Jack Warren Wade, who is an advisor to National Taxpayers Union and author of many books on tax compliance. Mr. Wade once headed the national revenue officer training program for the Internal Revenue Service.

Representative Johnson, we commend you for scheduling this hearing to examine taxpayers' rights. The IRS touches the lives of more American citizens than any other government agency. Because the IRS has more power than any other agency, it is especially important that Congress establish safeguards to protect the rights of taxpayers and to regularly maintain oversight of the tax collection power.

We strongly endorse S. 258, which is similar to the Taxpayer Bill of Rights II provisions in H.R. 11 of the 102nd Congress.

It's Time to Make the Ombudsman More Independent.

The 1992 House bill established a new position, known as the "Taxpayer Advocate" within the IRS. According to the Conference report on H.R. 11, this Taxpayer Advocate "replaces the position of Taxpayer Ombudsman. The Taxpayer Advocate is to be nominated by the President, by and with the advice and consent of the Senate." The final version of H.R. 11 was similar to the House bill, but S. 258 does not include a provision for making the Taxpayer Advocate a political appointee. This would be a serious mistake.

We strongly believe that the Taxpayer Advocate should be a political appointee and not a career IRS employee. As a political appointee the Taxpayer Advocate would be free to be a true taxpayer advocate without concern for his career aspirations within the IRS. He would not have to worry about how other IRS managers view his input into their areas of responsibility. Also, a political appointee would come to the job independent of the restrictive mission-oriented mentality that besets many career agency executives. He would be more receptive to the needs of taxpayers and to changing business-as-usual. A four-year term would enable each new administration to replace the Taxpayer Advocate.

Some have expressed concern about the Taxpayer Advocate being a political appointee. When he was Commissioner, Roscoe Egger once testified that such independent power "would not provide a balance between protecting the government's and taxpayers' interests and would open up dangerous potential for political abuse of the tax system." That's absurd. The Taxpayer Advocate would have no powers for such mischief. After all, the Commissioner is a political appointee. We're convinced that there is room in the IRS for one more political appointee. We believe there are proper checks and balances within the agency to prevent any political abuses or mischief. These include oversight from the IRS Internal Security Division and Treasury's Inspector General as well as an agency culture that resists political pressure.

We also support the proposal to mandate that the Taxpayer Advocate annually report "at least 20 of the most serious problems encountered by taxpayers, including a description of the nature of such problems" and to make "recommendations for such administrative and legislative action as may be appropriate to resolve problems encountered by taxpayers." This is a sound proposal. Much of the agency's emphasis has been on

ensuring taxpayer compliance, which is certainly part of the mission. But taxpayer compliance also can be increased by reducing problems and taxpayer frustration.

`We believe a provision should be added to require the Taxpayer Advocate to form advisory groups from the public and the tax industry to provide feedback about IRS operations and their effects on the taxpaying public.

Taxpayer Assistance Orders and the Problem Resolution Program.

While the Problem Resolution Program has undoubtedly achieved a great deal of success in helping taxpayers, we think there is still room for improvement. Reports have surfaced about problem resolution officers (PROs) who have not been helping taxpayers even though the circumstances appear to warrant intervention. Bob Kamman, a Phoenix, Arizona attorney, who contributes to our Tax Savings Report newsletter, has written that after a Form 911 is filed with a PRO, "that person refers it to the branch of the agency where the difficulty originated. The response quite often is made by the person who caused the problem in the first place. It's not easy to tell co-workers down the hall, who may eat at the same cafeteria table, ride in the same carpool and bowl in the same league, that they screwed up. Sometimes the PRO does it, but often he won't. That's what happened to my client ..."

I have heard complaints that some PROs believe they are not technically qualified to pass judgment on a particular taxpayer's complaint and temporarily overrule the IRS action. If this is indeed a problem, it would account for the dearth of Taxpayer Assistance Orders (TAOs) that have been granted.

The IRS will undoubtedly say that the reason for the dearth of TAOs is that the mere threat of a TAO often will accomplish the task. Mr. Kamman makes the excellent point that "we don't evaluate the effectiveness of police carrying guns by the number of times they shoot them." But the TAO is hardly the equivalent of a bullet.

The Standard of Hardship is Unnecessarily High for a TAO.

One other potential explanation is that the IRS is using an excessively strict standard of hardship. We strongly support the S. 258 provision to reduce the hardship requirement.

If the IRS is violating its internal policies or the tax laws, the Taxpayer Advocate should have the power to issue a TAO. This is altogether reasonable. After all, why should the taxpayer have to bear significant hardships in order to qualify for a TAO?

Mr. Kamman makes several sensible suggestions about how to liberalize the criteria to qualify for a TAO. He suggests that the following questions be considered:

1) Is the taxpayer falsely being accused of filing an incorrect return, or not paying taxes owed?

2) Is the taxpayer incurring expenses paid to tax professionals in an attempt to resolve a problem, not just to calculate a liability?

3) Did an admitted IRS error cause the problem in the first place?

4) Has there been an unreasonable delay in IRS remedial action?

If the answer to any of these questions is yes, hardship should be presumed de facto, and further inquiry into the particular burden of the hardship need not be made.

The Taxpayer Advocate should have the right to intervene in any enforcement proceeding or activity when a taxpayer has made a petition to the Ombudsman that at least one of the following conditions exist:

- There has been an improper or possibly illegal assessment.
- There has been an assessment made without the knowledge of the taxpayer and without benefit of the taxpayer's appeal rights.
- There has been an action in violation either of the statutory procedures of the Tax Code, the policies or regulations of the IRS, or the procedural requirements specified in the Internal Revenue Manual.

Taxpayers Can Still Lose Even When They Win.

Although the Taxpayers' Bill of Rights passed in 1988 offers important new protections for taxpayers, the job of protecting innocent taxpayers from ruin is far from

complete. For example, I have serious doubts that it would have prevented the well-documented Council family tragedy.

The original Taxpayers' Bill of Rights proposal would have allowed taxpayers to sue for damages if "any officer or employee of the Internal Revenue Service carelessly, recklessly or intentionally disregards any provision" of the tax laws. As the bill progressed through the Congress, the word "carelessly" was dropped from what became Section 7433 of the tax code.

Was the IRS treatment of the Council family careless and negligent? Absolutely. The Court's decision was clear on this point. Was it reckless or intentional? It might have been, but that is a very difficult standard to prove.

In the 1986 Tax Reform Act, Congress substantially liberalized the definition of negligent actions by individual taxpayers. During the 1980s, tax preparers have also been subject to increasing penalties for not exercising due diligence. Yet incredibly, Congress refuses to require the IRS to exercise reasonable caution in using its vast array of enforcement powers. We believe Congress should require the IRS to practice due-diligence in its enforcement actions in order to prevail in litigation where a taxpayer sues for damages. Congress should require that the IRS issue regulations defining a due-diligence standard for actions by its employees. We expect that the IRS would include the procedures already outlined in the Internal Revenue Manual as much of the criteria to define this standard.

Taxpayers who have been financially harmed or devastated by IRS carelessness in ignoring a due-diligence standard should have the right to sue and recover damages. We strongly support allowing taxpayers to recover damages for negligent action by the IRS. We also strongly support the proposal in S. 258 to raise the cap for damages to $1,000,000.

If a U.S. corporation makes a product that injures a consumer, consumers don't have to prove that the corporation recklessly or intentionally harmed the consumer in order for the consumer to win an award. Neither should a taxpayer who falls victim to the negligence of the all-powerful Internal Revenue Service.

I would also like to note a flaw in Section 7432 of the tax law. While it appears to allow a lawsuit for damages for failure to release a lien, it only applies for a failure to release a lien under Section 6325, not the imposition of the lien under Section 6321 in the first place. Legislation should correct this flaw.

Attorney Fee Awards Are Woefully Inadequate.

As Kay Council's case showed, taxpayers can suffer enormous financial damages even when they win. Kay was fortunate to receive an award of attorneys' fees for her case. But the fee award didn't come close to paying her total costs. She still owed tens of thousands of dollars.

While her attorneys billed her at $135 per hour and $90 per hour, depending on the respective seniority of the attorney, the judge was restricted by the outdated $75 per hour cap in the current law. He therefore only allowed reimbursement at a rate of $75 per hour and $49 per hour, leaving Kay to pay the difference. Does Congress want to say to future Kay Councils that they'll have to pay through the nose for legal help to fight a careless, incompetent or abusive IRS?

It's very difficult to win attorneys' fees. Also, the courts are extraordinarily reluctant to award attorneys' fees in excess of the $75 per hour cap in the current law. Proving special factors is almost impossible.

Unlike the standard for award of attorneys' fees in the Equal Access to Justice Act, plaintiffs in tax cases must prove that the IRS "was not substantially justified" in pursuing the case. It would be much fairer to require that the government prove it was acting reasonably in order to prevent an award of attorneys' fees.

To protect taxpayers from enormous financial losses incurred while fighting the IRS, we strongly support the proposal in S. 258 to raise the outdated $75 per hour cap to $110 per hour, then index it to inflation. The court would still be limited to awarding only "reasonable fees," preventing excessive awards. The proposed change that would allow taxpayers to collect more costs is also very important. We strongly recommend that the $110 per hour cap be lifted to $150, or at least reflect inflation since 1992. The original Senate bill of the 102nd Congress contained the $150 figure.

Taxpayers' Rights Review.

One provision of S. 258 would create a "1-year pilot program for appeals of enforcement actions (including lien, levy, and seizure actions) to the Appeals Division of the Internal Revenue Service." This is an excellent idea, and we hope that such a program would be made permanent. Had this proposal been in effect years ago, it may have prevented the Council family tragedy. It will certainly help ensure fair treatment during the tax collection process.

Taxpayers who are being treated unfairly by the IRS often don't have the financial means to mount an expensive court fight. This new administrative appeal procedure can help ensure fair treatment for taxpayers of modest means.

The Berlin Wall Stopping Taxpayers' Rights.

In the rare cases when the IRS goes out of control, federal law largely prevents the courts from allowing taxpayers to enforce their rights. The Federal Tort Claims Act allows the government to be sued in certain instances but specifically excludes "any claim arising in respect of the assessment or collection of any tax or custom duty." Of course, the 1988 Taxpayers' Bill of Rights granted two very limited exceptions to that rule.

Another unnecessarily restrictive law is the Anti-Injunction Act, the law that we call the Berlin Wall against taxpayers' rights. Mr. Chairman, it's past time to tear down this wall.

Under Section 7421 of the Internal Revenue Code, no lawsuit can be brought by any person in any court for the purpose of restraining the assessment or collection of any tax, except in limited circumstances.

The case law around the Anti-Injunction Act indicates many problems in obtaining injunctions to restrain the collection of the tax. It is clear that injunctions will be granted where the failure to grant relief would result in irreparable damage to the taxpayer. But an injunction will only be allowed where it is clear that under no circumstances would the government prevail (or the taxpayer would not owe the tax). Otherwise only two remedies are available to the taxpayer: 1) pay the tax, file a claim for refund, and sue for recovery if the claim is rejected; 2) file a petition in Tax Court before assessment and within the short period of time allowed for filing such a petition.

We think that the Anti-Injunction Act should be amended to give taxpayers the ability to enforce their rights if necessary. Taxpayers should be allowed to file suit in a federal district court to enjoin the IRS from enforcement action because: the deficiency assessment was made without knowledge of the taxpayer and without benefit of the appeal procedures provided by law; there has been an improper or illegal assessment; there has been an action in violation of the law or tax laws or regulations providing for procedural safeguards for taxpayers; the IRS has made an unlawful determination that collection of the tax was in jeopardy; the value of seized property is out of proportion to the amount of the liability if other collection remedies are available; or the IRS will not release the seized property upon an offer of payment of the U.S. interest in the property.

Then, there's also the Declaratory Relief Act. This law says that citizens can file suit to get a court to declare their rights "except with respect to federal taxes."

In author David Burnham's excellent book, A Law Unto Itself, he quotes California tax attorney Montie Day and his views on these laws that prevent taxpayers from enforcing their rights. He says that allowing such limited lawsuits would make "the IRS more accountable ... and make the agency more likely to operate in a lawful fashion."

To illustrate this point, he said "assume you are under audit and somehow you learn that the revenue agent has decided the best way to investigate you is to break a window of your office, climb through it and examine your correspondence.

"You come into my office for advice, wanting the court to rule that the IRS agent can't conduct his audit in this way. We consider filing a suit for declaratory relief, but then we remember that the court does not have the authority to issue such a declaration of rights in tax matters because of that exception in the Declaratory Relief Act.

"Then we think about requesting a court order to enjoin the agent from conducting his tax investigation by breaking into your office. This approach, of course, cannot be followed because the court is forbidden to even consider such requests under the Anti-Injunction Act."

As long as taxpayers are largely banned from suing to enforce their rights, taxpayers will continue to be at risk of financial ruin and emotional devastation from the

IRS. It is completely unfair for the IRS to have all the powers and for taxpayers to have few rights that can only be enforced with great legal difficulty. We must ensure fair treatment of innocent taxpayers to continue respect for our Constitutional system of government.

Congress Should Safeguard the Right to be Self-Supporting.

The Taxpayers' Bill of Rights made the very necessary improvement of exempting a larger amount of a taxpayer's weekly salary from levy. But it made little change in the amount of property exempt from seizure.

The law lifted the amounts from a paltry $1,500 for personal property to $1,650 and from $1,000 for equipment and property for a trade, business or profession to $1,100. That's hardly any change, and it is far from sufficient to allow a taxpayer to be self-supporting.

What self-employed plumber could maintain his self-employment with just $1,100 in tools, equipment and a truck? What computer programmer or author could do so? Very few, if any.

Who can provide the basic essentials of clothing and furnishings for a family with only a $1,600 exemption?

The bankruptcy laws provide far more protection than this. The Food Stamp program allows citizens to qualify for benefits with more assets than allowed under the tax laws!

We would like to see the exemption amounts lifted to either $10,000 or to provide the same protection as the bankruptcy laws. Many taxpayers are forced into bankruptcy court by the IRS. Raising the exemption amounts would take some of the load off the bankruptcy courts and safeguard the right to be self-supporting. The current levels are ridiculously low, and the proposed increases in S. 258 are not adequate to safeguard the right to be self-supporting.

Employees Who Abuse the Law Usually Go Unpunished.

There are many fine employees in the IRS who care about helping taxpayers comply with the law and who care about respecting taxpayers' rights. But given the sheer number of employees and the billions of tax returns and documents that are received by the IRS each year, it is inevitable that mistakes will be made and that some employees will act out of line.

The IRS has issued rules requiring tax preparers to exercise "due diligence" in the preparation of tax returns. In certain situations, preparers must cite "substantial authority" for the positions they take on tax returns. Failure to do so may result in monetary fines, being disbarred from practicing before the IRS, and a full scale audit of all the preparers' clients.

Yet IRS employees are often allowed to violate the IRS rules, regulations, policies, procedures, and guidelines at will and without fear of recourse. The law is so overwhelming and sweeping in its power conferred upon the tax collecting authority that there are few checks and balances on the exercise of that authority.

Taxpayers need more protections from arbitrary and capricious actions, and IRS employees should be held accountable for their violations. One theme that comes across again and again in Burnham's book is that the IRS almost always will not punish employees who make big mistakes in handling taxpayer disputes.

It seems clear that the IRS is more interested in controlling, regulating, and punishing taxpayers and practitioners for their violations than they are in controlling, regulating, and punishing their own employees for comparable infractions. If this double standard continues to exist, the compliance system as we know it could be in serious trouble.

Burnham reports a "disturbing footnote" about the occasions "when the IRS has crossed the line in its zealous enforcement of the tax laws: Agency officials involved in questionable activities are seldom punished." He also notes that many lawyers are worried "that the zealous, anything-to-win tactics are more and more becoming the accepted practice of the government." One of the fundamental principles of the U.S. Constitution is that people's rights shall be respected, even if it means that some people will escape being penalized for the laws they break.

Several years ago, Congressman Andy Jacobs introduced an amendment to a tax bill that would have permitted federal judges to make IRS employees personally liable for attorneys' fees paid by taxpayers who proved IRS agents acted arbitrarily and capriciously in pursuing the taxpayers. While this proposal may have gone too far, the concept is a good one - it would serve notice to IRS employees that they should be careful to protect taxpayers' rights.

Section 552(F) of the Federal Freedom of Information Act contains a standard that may be useful in drafting such a provision in the Federal tax law. It says that "Whenever the court orders the production of any agency records improperly withheld from the complainant and assesses against the United States reasonable attorney fees and other litigation costs, and the court additionally issues a written finding that the circumstances surrounding the withholding raise questions whether agency personnel acted arbitrarily or capriciously with respect to the withholding, the Special Counsel shall promptly initiate a proceeding to determine whether disciplinary action is warranted against the officer or employee who was primarily responsible for the withholding."

We expect the tax return preparers will be careful in preparing tax returns. Is it too much to ask that IRS employees and the agency be subject to some limited financial sanctions if they act to intentionally harm the taxpayer? We think not.

Installment Agreements.

Another provision of S. 258 would provide the right to an installment agreement if the taxpayer had not been delinquent in the previous three years and the liability was under $10,000. We think this is a good proposal, especially since it is limited to individual Form 1040 taxes. More taxpayers would be willing to concede to the IRS after an audit if they knew they would have time to pay an unexpected bill. Currently, taxpayers have an incentive to stall if they can't pay. Of course, any interest and penalties that would normally be owed would still continue to accrue.

Marriage, Divorce, and the IRS.

One of the most common complaints I hear comes from taxpayers who have divorced and one spouse has disappeared. Perhaps following a tendency in human nature, the IRS often goes after the spouse it finds first, whose name and address the IRS readily has on its computer, even though that spouse may be innocent.

Of course, in some cases, taxpayers can be relieved of the tax liability on a joint return under the so-called "innocent spouse" rule. However, its provisions are so complicated that it should be known as the "lucky spouse" rule for the few people who can meet all of its tests.

In one case in Arizona, the IRS dunned Carol Bettencourt, even though she had been divorced for five years. Her former spouse ran out on a court-ordered $60-a-month child support payments. Carol never saw a dime from him, but she was expected to pay his tax debts. Carol turned to the IRS Problem Resolution Officer, who told her that since she had once filed joint returns with her ex-husband, the only solution was to pay up.

But the Problem Resolution Officer failed to note that the IRS hadn't sent Carol's notice of tax deficiency to her last known address which the tax law requires. Fortunately, an attorney volunteered to review her case. With his help, Carol got her tax refund, which had been withheld to pay her husband's tax debt.

It is especially important to simplify and ease criteria that taxpayers must meet to qualify for protection as an "innocent spouse."

I don't see any reason why the IRS should not be required to honor divorce decrees that apportion responsibility for tax liabilities, provided that a decree splits such potential liability in proportion to the income earned by each spouse. A court could, for example, rule that in the last three years of marriage the husband earned 55 percent of the income and the wife earned 45 percent and thus require that any federal and state income tax liability that may be assessed against the couple be split accordingly to that ratio.

If the Congress is unwilling to do that, it should consider evenly splitting the liability between spouses. We currently have a situation that creates joint liability where the IRS tries to collect from one person -- an innocent spouse who is complying with the tax laws and is easier to find -- rather than from the responsible spouse, and that is often grossly unfair. The IRS should be required to pursue the spouse responsible for the tax problem. Any tax that arises from a business entity such a reported on a Schedule C should be apportioned to the spouse who owns the business entity. If additional tax arises from unreported income, the additional tax should be collected from the spouse who failed to report the income.

A divorced spouse should also have the right to petition the IRS for a final determination of any outstanding or potential tax liabilities. This would provide protection from a tax surprise on one spouse after a divorce is final.

I have heard reports that the IRS computer system is unable to set up separate collection accounts when the two divorced spouses live in different IRS districts. If this is true, then it is not simply a question of the IRS trying to collect the joint tax liability from the spouse who is located first, but the spouse whose case is being aggressively pursued by one of the two districts. Or, a Revenue Officer may determine that another spouse lives in another district and refer his case to the other district for collection. Case closed, problem transferred.

Much more needs to be done to protect divorced spouses.

Administration of the Federal Tax Deposit System.

If an employer does not report and deposit withheld income and Social Security taxes, then certain responsible officers can be held personally responsible for the taxes plus a one hundred percent penalty. This is an area ripe for reform.

When the IRS seeks to collect these trust fund taxes, it often assesses liabilities on everyone in sight (including bookkeepers, accountants, bank officers, inactive directors, inactive or resigned corporate officers and family members), whether they are truly a responsible officer or not. Inside the agency, this is called the shotgun penalty approach. A lot of innocent people get hurt.

Unfortunately, the burden of proof is on the taxpayer to prove that he or she was not responsible for the lack of payment. You might as well ask the taxpayer "When did you stop beating your spouse?" Proving a negative is a difficult proposition at best.

The burden should be on the IRS to prove the taxpayer was responsible.

Why can't the tax laws define the responsible parties as the chief executive officer, the chief and senior financial officers, those who serve on the board of directors and own a significant stake in a privately held corporation, and other responsible parties designated on a schedule that could be attached to the corporation's last quarterly 941 tax return of each year? The attached schedule would clearly state the serious responsibilities to remit trust fund taxes and require the signature of each named responsible person to indicate their knowledge of and consent to these rules.

If the IRS had the names and addresses of such persons in its computer, then these responsible persons could be immediately notified when a payment has been missed. It would allow these officers and other responsible persons to immediately investigate why these taxes have not been remitted on time, protecting the Treasury and innocent taxpayers.

Tax Complexity Invites Abuse.

Burnham wrote that an IRS instructor once claimed that he could find mistakes in 99.9 percent of tax returns. While he may have been exaggerating, he made a valid point.

The tax laws are so incredibly complicated that many taxpayers can't say with absolute confidence that they know the law or have filed their tax returns with 100 percent accuracy. Year after year, Money magazine reports that virtually all of the tax professionals who take its annual test for professional tax preparers made at least one mistake and they all come back with a different calculation of the tax liability!

This incredible variation opens up the potential for abuse. Vague laws allow enforcement abuses. If someone in the IRS wants to "get" you, the complex laws allow the agency to make a plausible case against virtually anyone.

We hope that this Congress will thoroughly examine proposals by Congressmen Bill Archer and Dick Armey to scrap the current income tax system in favor of a greatly simplified sales or flat rate income tax.

Congress Should Require Equitable Use of the Levy Power.

Burnham's book presents an impressive array of statistics that the levy power is not applied equally across the United States. Burnham reports that in 1988 "for every 1,000 tax delinquent accounts, 892 levies [occurred] in the Western Region; 860 in the Mid-Atlantic; 735 in the Southwest; 714 in the North Atlantic and the Central; 708 in the Mid-West; and 532 for the Southeast."

There's even more variation in the seizure rate. Burnham reports that in 1988 "the seizure rates in the most active districts were 30 to 40 times higher than the rates in the districts with the least. The IRS has no explanation for the variations."

This is nothing new. As far back as 1976, the Administrative Conference of the United States issued a report titled "Collection of Delinquent Taxes" that said the IRS had no clear guidelines specifying when levy action was to be taken. The report said "lacking guidance, revenue officers vary in their criteria for seizure of assets of individual taxpayers ... So long as the Internal Revenue Service fails to delineate clear purposes for the use of summary powers, we believe that these divergent criteria will continue to exist. The variations in practice may lead to the appearance of arbitrariness and caprice in some actions, thus undermining the taxpaying public's confidence in (and compliance with) the taxing system."

These random variations have continued year after year. The guidelines that exist only in Internal Revenue Manuals are not enforceable. Therefore, Congress should require that the IRS issue regulations specifying the circumstances, conditions and situations under which a levy will be made.

Conclusion.

The job of protecting taxpayer rights will never end. Much progress has been made, but more legal protections are necessary. We sincerely appreciate the efforts being made by members of this subcommittee to formulate legislation to better protect taxpayer rights.

Chairman JOHNSON. Thank you, very much.

Mr. Thayer, president and CEO of the National Association of the Self-Employed.

STATEMENT OF BENNIE L. THAYER, PRESIDENT AND CHIEF EXECUTIVE OFFICER, NATIONAL ASSOCIATION OF THE SELF-EMPLOYED

Mr. THAYER. Madam Chairman, and Mr. Hancock, I appreciate the opportunity to testify here today before this subcommittee on oversight. My name is Bennie L. Thayer, and I am president and CEO of the National Association of the Self-Employed.

And may I also, at the outset, thank you, Madam Chairman, for your efforts on behalf of those businesses who operate from their home and coupled with the efforts of Representative Hoagland and Representative Archer. We certainly appreciate those.

Our more than 320,000 members of the NASE, 85 percent of whom have five or fewer employees, have a great deal of concern about the initiatives of this type that tend to protect their rights.

According to a recent NASE survey 82.4 percent of the respondents stated that the IRS imposed the greatest regulatory burden on their business when compared to other agencies. It is for this reason that the NASE welcomes the opportunity to comment today on taxpayer right's proposal.

The House Ways and Means Committee has an excellent track record of supporting efforts to improve taxpayers' rights, and we clearly appreciate and recognize the committee's long standing tradition of fighting for taxpayers' rights.

That includes its involvement in the final passage of the Taxpayer Bill of Rights in 1988, and also in the drafting of the 1992 Taxpayer Bill of Rights II.

We believe today that there are a number of measures found in the 1992 legislation which could serve as a starting point for the drafting of the taxpayer rights legislation which you are considering today.

I would like to just talk about three of those momentarily, if I can. The first one is that we strongly support the provisions contained in the 1992 legislation which called for changes to the structure of the IRS office of the taxpayer ombudsman. The 1992 legislation restructured, as you know, the office of the taxpayer ombudsman and in its place, established the office of the taxpayer advocate. You have just heard a reference to that.

That legislation made the new taxpayer advocate a political appointee, and accountable to Congress. We, too, as you have just heard, believe strongly that this should happen.

The NASE strongly supports the inclusion of this proposal in any 1995 legislative initiative. We reject and we reject vehemently any arguments that an independent taxpayer advocate will result in a politicized office.

Previous presidents and congresses have nominated and confirmed people of outstanding abilities and reputations for the IRS positions of commissioner and chief counsel and we believe that future presidents and congresses will do the same thing.

The 1988 Taxpayer Bill of Rights gave the ombudsman the authority to issue taxpayer assistance orders. And although the tax-

payer assistance orders program is pro-taxpayer when we consider it on its face, only a limited number of taxpayer assistance orders have been issued over the years. Therefore, the NASE strongly recommends that the authority a newly created taxpayer advocate position also be expanded to ensure more effective utilization of taxpayer assistance orders on behalf of legitimate cases of taxpayer hardship.

Second, I would draw to your attention from the 1992 version, the prohibition on the Treasury and the IRS from issuing regulations having a retroactive impact on taxpayers.

To the average small business person retroactive regulations create perception problems for the Federal Government. A taxpayer should not be penalized for his or her good faith reliance on a tax law or regulation which was, indeed, the law of the land one day, although it might have been changed the next day.

The NASE believes that a prohibition on retroactive tax regulations will increase the average taxpayer's faith in the tax administration process and thus, should result in an improvement in tax compliance by the public.

Finally, the third thing I will mention although it was not included in the final House and Senate conference report of 1992, it was in the House version of the bill of rights. That was a measure that made IRS employees personally liable in situations of clear abuse.

The NASE strongly supports this proposal. We reject arguments that such a measure would change the balance of persuasion, if you will, between taxpayers and the IRS employees in the audit situation. Even with enactment of a measure that makes IRS employees personally liable for any egregious acts of misconduct, the NASE strongly contends that the power to intimidate the taxpayer will still remain with the IRS auditor.

If it is not politically feasible to make IRS employees personally liable for egregious acts of misconduct, we then recommend that Congress increase the limits on civil damage awards under the Internal Revenue Code section 7433 and we recommend that they be increased to $1 million from their current $100,000 level.

Section 7433 permits a taxpayer to bring a civil action in district court against the United States if an IRS officer or employee has recklessly or intentionally disregarded the tax law with respect to the collection matter. The NASE believes that a $1 million threshold will send a strong and, I repeat, a very strong message to IRS employees and help deter the egregious acts of misconduct that you have heard represented here today.

We thank you for this opportunity.

[The prepared statement follows:]

TESTIMONY OF BENNIE L. THAYER
NATIONAL ASSOCIATION FOR THE SELF-EMPLOYED

On behalf of the National Association for the Self-Employed, I appreciate the opportunity to testify before the House Ways and Means Subcommittee on Oversight. My name is Bennie L. Thayer, the NASE's President; and I am pleased to testify today on the Taxpayer Bill of Rights and other proposals to improve the rights of taxpayers in their dealings with the Internal Revenue Service.

Taxpayer rights proposals are extremely important to the over 320,000 members of the NASE, individuals who operate businesses throughout the United States. Over 85 percent of the NASE members are business owners with 5 or fewer employees. The membership represents a very wide range of businesses, notably in the consulting and retail fields. If you ask the average NASE member which federal agency creates the greatest number of administrative burdens and headaches for their business, the answer will usually be the IRS.

According to a recent NASE survey, 82.4 percent of the respondents stated that the IRS imposed the greatest regulatory burdens on businesses when compared to other agencies. It is for this reason that the NASE welcomes the opportunity to comment on taxpayer rights proposals. We strongly support efforts to improve the privacy rights of taxpayers and ensure a more even-handed approach to enforcement of the tax laws. The NASE believes such efforts should lead to an increase in the respect taxpayers have for the tax administration process and thus, result in a meaningful increase in taxpayer compliance rates overall.

The History of Efforts to Improve Taxpayer Rights

The House Ways and Means Committee has an excellent track record of supporting efforts to improve taxpayer rights. We clearly appreciate and recognize the committee's long-standing tradition of fighting for taxpayer rights, including its involvement in the final passage of the Taxpayer Bill of Rights in 1988. The NASE also commends the committee for its active involvement in the passage by Congress of the Taxpayer Bill of Rights II ("T2") in 1992; however, it did not become law because the proposal was included in two broader tax bills which President Bush vetoed in 1992 for reasons unrelated to T2.

The 1988 Taxpayer Bill of Rights made a number of improvements to the tax administration process, as well as created a number of new rights for taxpayers overall. As a result of the 1988 law, the IRS is now required to disclose in simple and nontechnical terms, the rights of a taxpayer in his or her dealings with the IRS, including with respect to an audit or tax collection matter. The IRS fulfills this requirement through the issuance of Publication 1, entitled, "Your Rights as a Taxpayer." Also, the 1988 law mandates the IRS abate any penalties or additions to tax attributable to erroneous written advice provided by the agency. The Taxpayer Bill of Rights further requires the Service to issue all temporary regulations as proposed regulations -- with the proviso that any regulation that remains in temporary form for a 3 year period shall expire at the end of such time period.

Other beneficial provisions of the 1988 law include (among others) the right of the IRS Office of Taxpayer Ombudsman to issue taxpayer assistance orders, improvements in the standards regarding when a taxpayer may interview a client, legislative authorization that the IRS may enter into written installment agreements with a taxpayer for the payment of taxes, and the establishment of an IRS Office of Taxpayer Services.

The Beneficial, Pro-Taxpayer Provisions of the Taxpayer Bill of Rights II

The NASE believes there are a number of beneficial pro-taxpayer provisions contained in the 1992 Taxpayer Bill of Rights II and therefore, we recommend that the House Ways and Means Committee include these specific provision in any final taxpayer rights initiative acted upon during 1995 or 1996.

1.) IRS Office of Taxpayer Advocate

We believe T2 was a carefully crafted initiative which balanced the interests of the IRS and the tax administration process with a taxpayer's privacy and due process rights.

First, we strongly support the provision contained in the 1992 legislation which called for changes to the structure of the IRS Office of Taxpayer Ombudsman. IRS Commissioner Jerome Kurtz established the Ombudsman position in 1980, a position which currently has civil service status and currently reports directly to the Commissioner. The office was established because Kurtz wanted to help taxpayers who believed they were not getting their problems addressed through traditional IRS channels.[1] In 1988, with the passage of Taxpayer Bill of Rights I, the Ombudsman's office was given statutory sanction and authority.

The 1992 legislation restructured the Office of Taxpayer Ombudsman and in its place, established the Office of Taxpayer Advocate. T2 made the new Taxpayer Advocate a political appointee and accountable to Congress. That is, T2 made the Taxpayer Advocate independent of the Commissioner's direct line of authority. The NASE strongly supports inclusion of this proposal in any 1995 legislative initiative. While the NASE appreciates the IRS' stated purposes regarding the current Office of Ombudsman, we strongly believe an independent Taxpayer Advocate will greatly contribute to a more taxpayer friendly atmosphere among IRS auditors.

We reject any arguments that an independent Taxpayer Advocate will result in a "politicized" office. The IRS currently has two positions subject to political appointment -- and these are the offices of IRS Commissioner and Chief Counsel. Previous Presidents and Congresses have nominated and confirmed people of outstanding abilities and reputations for these two positions, and we believe future Presidents and Congresses will continue to act in a similarly "good government" fashion. We have immense confidence that the federal government's dire need for revenues will act as a brake on any serious attempts to politicize the Office of Taxpayer Advocate.

The duties and responsibilities of the current Office of Taxpayer Ombudsman are (under the current IRS administrative structure) carried out at the local level by the Problem Resolution Offices located in the IRS district offices and service centers. The Problem Resolution Program is very beneficial to taxpayers in that the program has been set up to help taxpayers who are unable to resolve their problems through normal IRS channels. Unfortunately, the Ombudsman's role can potentially be undercut at the local level since the Problem Resolution Officers are hired and supervised by the local IRS District Director. Therefore, in order to mitigate the potential for any resistance to helping a taxpayer with a significant problem at the IRS local level, we recommend that the Problem Resolution Officers report directly to a newly created Office of Taxpayer Advocate.

As stated previously, the 1988 Taxpayer Bill of Rights gave the Ombudsman the authority to issue Taxpayer Assistance Orders (TAO). A taxpayer can apply to the Ombudsman and ask him to issue a TAO based on the fact the taxpayer is suffering significant hardship due to an IRS collections effort. If warranted, the TAO can require the IRS to stop certain collection efforts, such as removal of a levy on the taxpayer's property. Although the TAO program is pro-taxpayer on its face, only a limited number of TAOs have been issued over the years. Therefore, the NASE strongly recommends that the authority of the current Ombudsman (or in the alternative, a newly created Taxpayer Advocate program) be expanded and broadened to ensure more effective utilization of TAOs on behalf of legitimate cases of taxpayer hardship.

2.) Prohibition on Retroactive Regulations

The NASE strongly supports the measure contained in the 1992 version of T2 which prohibited (except under certain limited circumstances) the Treasury and IRS from issuing regulations which have a "retroactive" impact on taxpayers. According to proponents of the 1992 legislation, this measure was a direct reaction of widespread practices by Treasury during the 1980s, in which the agency offered "temporary regulations which became effective

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[1]Zeidner, Rita L., "Taxpayer Rights and Collecting Taxes: Striking a Delicate Balance", *Tax Notes*, November 12, 1992, page 832.

immediately upon their publication."[2]

To the average small business person, it does not matter whether a federal agency has meritorious technical and/or substantive reasons for issuing a regulation which has a retroactive impact on a taxpayer's affairs. Retroactive regulations -- rightly or wrongly -- create perception problems for the federal government which are viewed by a small business person as being arbitrary on their face. A taxpayer should not be penalized for his or her good faith reliance on a tax law or regulation which was the "law of the land" one day and changed the next. We wholeheartedly support an effort to prohibit retroactive tax regulations. The NASE believes that a prohibition on retroactive tax regulations will increase the average taxpayer's faith in the tax administration process and thus, should result in an improvement in tax compliance by the public.

3.) Make IRS Employees Personally Liable for Clearly Abusive Acts

Although not included in a final House-Senate conference report in 1992, the House version of T2 included a measure which made IRS employees personally liable in situations of clear abuse. The NASE strongly supports this proposal. We reject arguments that such a measure would change the "balance of persuasion" between taxpayers and IRS employees in an audit situation. The NASE does not agree with arguments that this type of proposal is likely to result in taxpayers intimidating IRS auditors into readily agreeing with the taxpayer's position on audit. In act, when a small business person faces an IRS audit, we firmly contend it is the IRS agent which has the power to intimidate -- not the taxpayer.

Even with enactment of a measure which makes IRS employees personally liable for any egregious acts of misconduct, the NASE strongly contends that the power to intimidate the taxpayer will still remain with the IRS auditor. If nothing else, this kind of proposal would serve to curb to a modest degree the most outrageous acts of misconduct by an IRS employee.

If it is not politically feasible to make IRS employees personally liable for egregious acts of misconduct, we recommend that Congress increase the limits on civil damage awards. Internal Revenue Code Section 7433 permits a taxpayer to bring a civil action in district court against the United States if an IRS officer or employee has "recklessly or intentionally disregarded" the tax law with respect to a collection matter. The current statutory limit for such civil actions is $100,000. We strongly recommend that this threshold for taxpayer civil causes of action against the U.S. be raised to $1 million. The NASE believes that a $1 million threshold will send a strong message to IRS employees and help deter egregious acts of misconduct.

4.) Expanding the Ability of Taxpayers to Recover Reasonable Costs

Section 7430 of the Internal Revenue Code permits a court to award a judgment to a taxpayer for reasonable costs associated with an IRS administrative proceeding or tax litigation case. Such an award can be made to a taxpayer who establishes to the court that the government's position in the tax case was not substantially justified. The Code requires the taxpayer to exhaust all the administrative remedies available to him or her before the court can make an award of reasonable administrative or litigation costs regarding the tax dispute.

Senators David Pryor, Charles E. Grassley and others this year introduced S. 258, a very positive, pro-taxpayer initiative. Among other provisions, S. 258 permits a taxpayer -- once he or she has substantially prevailed in his or her case with the IRS -- to file a petition in court for disclosure of all information and copies of relevant records in the possession of the IRS associated with the case. Also, S. 258 increases the level of attorney fees that a taxpayer may recover from the government under Code Section 7430. In general, this

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[2]Kirchheimer, Barbara, "ABA Panel Examines Problem Areas in Taxpayer Bill of Rights", *Tax Notes*, September 7, 1992, page 1263.

particular provision increases the level of reasonable attorneys fee from $75 per hour to $110 per hour, and indexes the amount to inflation.

The NASE views Section 7430 as a powerful measure which is designed to dissuade the IRS from bringing unwarranted and egregious collection cases against U.S. taxpayers. Therefore, we are particularly supportive of the above provisions contained in S. 258. These provisions should provide taxpayers with improved privacy protections, as well as help level the playing field for taxpayers when faced with an unwarranted IRS position in a tax dispute.

5.) Other Positive Initiatives Under T2

There are a number of other pro-taxpayer proposals found in the 1992 version of T2 and in bills introduced in 1995 that the NASE strongly supports. First, we endorse an expansion of the rights and circumstances when small taxpayers may use installment agreements to pay a tax deficiency. Last, we urge that any final 1995 legislation protecting taxpayer rights include a requirement that the IRS abate interest when the agency is responsible for an unreasonable error or delay with respect to the agency's tax administration functions.

Chairman JOHNSON. Thank you for your very interesting testimony.

Mr. William Stevenson, president of the National Tax Consultants, on behalf of the National Society of Public Accountants.

STATEMENT OF WILLIAM STEVENSON, PRESIDENT, NATIONAL TAX CONSULTANTS, INC., ON BEHALF OF THE NATIONAL SOCIETY OF PUBLIC ACCOUNTANTS

Mr. STEVENSON. Good afternoon, Madam Chairman, Congressman Hancock, Congressman Portman. My name is Bill Stevenson, and I am here today in my capacity as chairman of the Federal Tax Committee of the National Society of Public Accountants.

NSPA consists of 20,000 independent accountant members serving 5 million small businesses and individuals throughout the country, and our membership consists of CPAs, enrolled agents, licensed public accountants, and other professionals serving smaller businesses. I, myself, am an enrolled agent, and I also hold a special license which allows me to practice before the U.S. Tax Court as a nonattorney.

I am not going to speak about the issues in the bill that everyone has been talking about today. I generally agree with just about everything that has been said. How could you not? But there are two issues I am going to laser-focus on that, if adopted, will greatly improve some of the things that we were discussing earlier.

The regrettable story of Mrs. Howden, while it really bothered us all to our hearts, I want you to know I come from the front lines. I am speaking to you here today after leaving cases like this and finding it very frustrating to deal with issues to help resolve taxpayer problems before the Internal Revenue Service.

The one problem that we are all having is the inconsistency of treatment throughout the country. One good example of inconsistent treatment, for example, is the Internal Revenue Service's program of offers in compromise. It is a program that was rewarmed about 2 years ago because the Internal Revenue Service felt that there was a lot of tax money out there that they could collect, but because of the circumstances of the individuals, it was not possible to get the money under such circumstances. So they—IRS—developed the offer in compromise program.

National Office made a policy. The problem is the policy was interpreted differently in 63 different districts throughout the country. So, Madam Chairman, if one of your constituents filed an offer in compromise, they might have a 40-percent chance of getting it approved. If somebody from Missouri filed an offer in compromise, they might have an 80-percent chance of it getting approved. If somebody from the districts that I worked, the Manhattan and Brooklyn districts, filed an offer in compromise, we would be lucky to get 25 percent or less approved.

It is different in every single district throughout the country. Some districts even say, "X district's offer in compromise policy," rather than Internal Revenue Service's offer in compromise policy.

The IRS employs over 100,000 individuals, probably closer to 110,000 people, and these individuals all have a different set of personal standards and values. While we recognize that the diversity that they have is important because it helps any organization

thrive, the problem that we have is balancing the diversity within the Service with our expectation of equal and fair treatment.

One way we can guarantee, almost, equal and fair treatment is through the Internal Revenue Service manual. I am not sure whether it is apparent to everyone, but when Congress passes Federal tax law, there are two things that happen. It asks the Internal Revenue Service to issue regulations based on that law, and the American public has to follow those regulations. If they don't, they can be penalized, fined, and even be sent to jail. On the other hand, the Internal Revenue Service is required by Federal law to write a manual for its own employees, so you don't have rogue employees running amuck throughout the different districts and making their own policy.

The sad fact is they don't have to follow that manual, and there are many court cases where the IRS was taken into court and said, "Gee, you guys aren't following the manual and you are causing us financial problems because of it." And the courts have ruled in many, many cases—I have 15 of them listed here—that the Internal Revenue Service manual does not have the weight of law, and, therefore, the Internal Revenue Service does not have to follow it. That is one of the reasons why you have this diversity of treatment of taxpayers all over the country.

Congress can enact legislation saying that the Internal Revenue Service manual has the weight of regulation, and it will be given equal status so that if the Service does not follow its own rules and regulations, then you can go to court and get some kind of redress.

Why should the IRS be allowed to write rules and regulations that the public has to follow, and when they write their own rules and regulations, they don't have to follow them? It certainly is a strange paradox.

I realize—my time is up. There was only one more thing I wanted to mention if you could give me a second.

Chairman JOHNSON. Go ahead.

Mr. STEVENSON. The IRS has instituted recently audit-like activities that they call compliance checks. This allows the Service to come into our office and review files. For example, if one of your constituents was in my office and we had an interview that dealt with more than taxes and I put the information in a file and we filed the return electronically, the Service could come into our office, demand to see their file simply because they filed electronically, without the permission of the taxpayer and without due process. There are many examples of this, not only in that area but in others as well.

We think this is really a violation of taxpayers' rights on a very broad scale, and we would like you to redress that problem, too.

I know the Service has dedicated people. We work very closely with them. But we do need to face the problem of inconsistency, and I think you have it within your means to do so.

In closing, I would like to thank you for the invitation to appear before the subcommittee today. These precious 5 minutes that you allowed me make me really proud to be an American, and NSPA stands ready to assist you in your efforts in every way possible.

[The prepared statement follows:]

TESTIMONY OF WILLIAM STEVENSON
NATIONAL SOCIETY OF PUBLIC ACCOUNTANTS

I. Introduction

On behalf of the 20,000 members of the National Society of Public Accountants (NSPA) and the 5 million small businesses and individuals they serve, I would like to thank Madam Chair and the members of this Subcommittee for the opportunity to express the Society's views on the development of "Taxpayer Bill of Rights II" (TBRII) legislation. The Society feels that the current Taxpayer Bill of Rights provides a great deal of assistance and comfort to the public in dealings with the Internal Revenue Service. However, our members have identified several areas in which the first bill could be more effective. First, a new bill of rights should promote consistency within the Internal Revenue Service in its treatment of similarly situated taxpayers. For example, taxpayers in Connecticut should be confident that they are treated similarly to taxpayers in California. Second, TBRII should empower the Internal Revenue Service to act more quickly in serving the taxpayer. Third, an expanded bill of rights should include protection for tax practitioners, who work daily to ensure that the proper amount of taxes are reported and paid. Finally, a new bill of rights should make certain that taxpayers know when they are being examined and exactly what rights they have in that particular examination.

II. Consistency Within the Internal Revenue Service

Currently, the IRS works in this country through seven regions which are further subdivided into sixty-three districts. In addition, there are ten service centers around the country which provide the main contact point for many taxpayers.[1] These centers receive most of the returns, letters and phone calls from the general public. Within this infrastructure, the Service employs over 100,000 individuals, each with a different set of personal standards and values that influence the way they perceive and serve taxpayers. This diversity is a vital asset to the organization, creating more insightful decisions by drawing from varied viewpoints. The problem for the Internal Revenue Service is balancing this diversity with the expectation of taxpayers that the Internal Revenue Code be administered consistently throughout the country.

A. Offers in Compromise

The offer-in-compromise (OIC) program provides an example of the difficulty the Service faces in administering the tax code through its thousands of employees. In 1992, OICs received a new emphasis at the IRS as a means to reduce the troublesome amount of debts labelled "currently not collectable." In that year, the program was expanded to allow those in financial difficulty to pay what they could and settle their federal tax liability. The procedure involves preparation by the taxpayer of an offer which accurately reflects his or her ability to pay off a federal tax debt. This offer is then submitted to the Internal Revenue Service, where it is accepted or rejected depending on the Service's analysis of the taxpayer's ability to pay.

According to a 1994 survey by Tax Analysts[2], taxpayers submitting an offer in compromise in 1993 had anywhere from a 79% likelihood of acceptance in Mississippi to a 19% likelihood of acceptance in California's Laguna Niguel district. On average throughout the country, 53% of offers were accepted. Taxpayers in Utah offered an average of 3 cents on the dollar in order to gain acceptance, while acceptable offers by taxpayers in New Hampshire averaged 31 cents on the dollar. The national average required for acceptance was 15 cents on the dollar.

This program points out the need for an IRS focus on consistency from the inception of a regulation or a program, rather than after a problem has arisen. It should be noted that since the publication of the above-mentioned survey, the Service has taken steps to promote consistency in the offer-in-compromise program. NSPA would like to suggest a provision for TBRII that could enhance consistency before such wide disparities come to light. Give the Internal Revenue Manual the force and effect of law, an action that would require IRS personnel around the country to follow the same guide.

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[1]Current plans indicate that these numbers will be subject to change in the near future.

[2]Guttman, George, "Compromise Offer Acceptance Rates Vary by Location," Tax Notes, Vol. 62, Number 3, Monday, January 17, 1994.

B. The Internal Revenue Manual

Today, the IRS invests substantial amounts of money every year in updating and revising the Internal Revenue Manual. It provides guidance to Service employees on every facet of the revenue collection process. Generally, it is available for public inspection. Millions of Americans are directly affected by the provisions of the manual and the interpretations thereof. However, in a line of precedent dating back to Sullivan v. U.S., 384 U.S. 170 (1954) and recently restated in Capitol Federal S&L, 96 T.C. 204 (1991), "[G]eneral statements of policy and rules governing internal agency operations or 'housekeeping' matters, which do not have the force and effect of law, are not binding on the agency issuing them and do not create substantive rights in the public." Consequently, if a taxpayer goes to court solely because an Internal Revenue Service employee failed to follow the manual, the taxpayer will lose that claim.

The Capitol Federal S&L case goes on to say that, "Generally, agencies are bound by regulations having the force and effect of law." In order to bind the IRS to the guidelines it sets forth in its manual, NSPA asks this Subcommittee to initiate legislation to give the Internal Revenue Manual the force and effect of law.

The manual's current lack of regulation status leads to inconsistency in the tax system because individual districts develop different methods for handling similar problems. Those methods do not necessarily agree with the national office policy as set forth in the Internal Revenue manual. To use the offer-in-compromise program again as an example, I know from personal experience of at least one district that has its own separate manual for offers in compromise. In that same district, when I reminded a revenue agent that an action he was about to take violated a national office policy, I was told, "That may be national policy, but it's not the policy in [this] district." Such inconsistencies are unfair to the taxpayer. The best solution to the problem is to require the IRS to live by the rules it puts forth for itself in the same manner that taxpayers are required to live by the rules that the IRS puts forth for them.

This is not to say that districts should not be allowed some flexibility. Clearly, in an organization as large as the IRS, not all solutions will work effectively for all parts of the country. If this subcommittee should agree that the manual should have the weight of regulation, we would also request that a process should be created whereby districts can petition the national office and be granted a right to develop their own guidelines on certain projects. These guidelines should then be released to the public. With public access allowed, taxpayers would have an opportunity to be aware of differences between national office policies and district policies before relying on either one. And, once a taxpayer relies on an IRS policy, he or she would have the comfort of knowing that it would stand up in court.

It is not NSPA's intention to handcuff the Internal Revenue Service with either of these proposals. In a system where diverse individuals analyze an Internal Revenue Code that is at times ambiguous and subject to varying interpretations, strict uniformity is obviously unattainable and to some extent even undesirable. However, a federal law should be administered as uniformly as is practical throughout the country. Today, that does not always happen. To remedy the current difficulty, NSPA respectfully recommends that this subcommittee consider giving the Internal Revenue Manual the force and effect of law. This would help to move the Internal Revenue Service toward a more consistent application of the tax law throughout the country.

III. Empowering the IRS to Serve Taxpayers More Quickly

Many taxpayers dread the receipt of an IRS notice not only for the possible monetary penalties that it may entail, but also for the loss of productivity that invariably follows as efforts are made to rectify the problem. This drain on resources is a substantial component of the cost of compliance, whether the money is spent on staff time, representation fees, or both. As a result, taxpayer rights that allow certain issues to be resolved quickly while still being fair to both sides are worthy of support. S. 258 contains a provision that is particularly helpful in this area and NSPA would like to submit another for your consideration.

A. Support for Section 501 of S. 258

Section 501 of S. 258 would allow the Internal Revenue Service to withdraw certain notices of

liens. Under current law, once the IRS places a lien on a taxpayer, it cannot be released until the full debt is settled. Often this hinders the taxpayer's ability to repay the money, as it limits the funds available through borrowing. Section 501 would allow the withdrawal of such a notice by the Service for several reasons, including facilitating the collection of the tax liability. NSPA supports this provision because of its common sense approach to removing liens where they hinder the taxpayer's ability to repay a debt.

B. Request for a Limited Power of Attorney Sign Off on Tax Returns

Another item which is currently in limited use by the Internal Revenue Service but which could be expanded to all returns is a limited power of attorney sign off directly on a form. Today, taxpayers who file electronically sign a Form 8453. In addition to meeting the signature requirement for the taxpayer's individual return, this form also allows the IRS to call the practitioner who transmitted the return in the event that any problems arise which delay the taxpayer's refund. The Form 706 estate tax return also includes a signature line which allows a practitioner to act as the estate's representative before the Internal Revenue Service.

Similar authorizations could save time and otherwise reduce taxpayer burden if they were included on all tax returns. Currently, practitioners who prepare returns for their clients sign the forms, but they are not empowered by that signature to discuss the return with the IRS. When taxpayers receive notices from the Service, their first call is usually to the person who prepared the return. The preparer in turn calls an IRS agent who asks, "Do you have a power of attorney on file?" Most often, this is not the case and the resolution of the problem is delayed while the proper form is completed and filed. If the taxpayer could assign a limited power of attorney on the return at the time of filing, the notice would still be sent to the taxpayer and the taxpayer would still, most likely, call the practitioner. The difference would be that the limited power of attorney would enable the practitioner to discuss the return with the Service immediately and to begin taking whatever steps are necessary to resolve the problem.

Provisions like these, which allow the Service and/or the practitioner community to more quickly resolve taxpayer problems when they arise are valuable elements of a taxpayer bill of rights. By saving taxpayer time, these provisions reduce the drain on taxpayer resources that can be caused by IRS notices. NSPA requests that this subcommittee consider section 501 and a limited power of attorney for inclusion in a taxpayer bill of rights.

IV. Protection for Practitioners

Within the tax system, practitioners provide many services to the taxpayer. Among the most important functions a practitioner performs is that of liaison between the IRS and the taxpayer. As a result, any discussion of taxpayer rights will, of necessity, include issues that impact the practitioner community. NSPA would like to raise two concerns with respect to practitioner rights in relation to the Internal Revenue Service.

A. Recognition of Powers of Attorney Before the Internal Revenue Service

First, many practitioners routinely experience difficulty in having IRS field personnel honor the valid powers of attorney described above. All too often, IRS employees make direct contact with taxpayers, even after receiving a power of attorney authorizing representation by an attorney, CPA or enrolled agent. In such instances, the taxpayer generally is either unaware that such conduct is improper or is afraid to question the propriety of the contact for fear of alienating the IRS employee.

NSPA recognizes that legitimate circumstances may on occasion necessitate a direct taxpayer interview. Nevertheless, where a power of attorney is on file, such an interview should be arranged through the authorized representative and conducted in that representative's presence.

This improper disregard of a power of attorney compromises the rights of both practitioners and taxpayers. NSPA believes that safeguards should be established, such as some appropriate form of sanction, to discourage this practice.

B. Removal of Preparer's Social Security Number from Tax Returns

Second, the practitioner community is becoming increasingly concerned with the requirement that a paid preparer's social security number must appear on returns. Currently, practitioners are required to include their social security number on every return they prepare. In today's world of instant access to volumes of sensitive information about an individual, the social security number is often the key to obtaining this information. Preparers feel that the requirement that they include their social security number on returns violates their privacy, as it provides the client with the opportunity to acquire certain records that would not otherwise be available. NSPA suggests that this committee review this requirement with the Internal Revenue Service and develop a separate system for identifying tax preparers.

V. Knowledge of Examination and Rights Therein

The first taxpayer's bill of rights focused heavily on making sure that taxpayers were aware of their rights in an examination and that those rights were protected. Since passage of the first bill, the IRS has created several new types of examinations. Questions have arisen regarding what a taxpayer's rights are under these new exams and often practitioners hear various answers. Two examples come to mind which illustrate the continuing need for legislation to protect basic taxpayer rights.

A. Current Examination Examples

First, the Internal Revenue Service now conducts electronic filing (ELF) compliance checks. This check often consists of a revenue agent and a member of the Service's criminal investigations division arriving at a practitioner's office, sometimes announced. The Service personnel are there to monitor compliance with the revenue procedures that govern electronic filing. The problem is that there are no clear guidelines on what these Service employees are supposed to be reviewing. Some agents ask only to see basic paperwork, while others demand the entire supporting file on the return. In addition, it can involve a review of taxpayer returns and supporting documents without notice to the taxpayer.

Another example of this problem is an examination known as an employment tax compliance check. In this procedure, the IRS sends a notice to a taxpayer stating that the Service will arrive at the taxpayer's place of business on a specific date to review compliance with employment laws. The notice requests that the taxpayer provide copies of all current employment-related returns, all of which the taxpayer has already filed with the IRS. When NSPA asked the Internal Revenue Service whether or not a taxpayer who received a notice of this examination was required to comply, the answer was no. Taxpayers can refuse to provide the information and basically tell the IRS, "If you want to audit me, do so." Nowhere in the letter for this examination is the taxpayer informed of the right of refusal.

B. Recommendation for Specific Notice

Taxpayers and practitioners undergoing these examinations have a right to know exactly what is required of them under the circumstances. The Service has in some cases been responsive to NSPA concerns about explaining the rights of a taxpayer in every examination situation. However, Service action often comes after the programs are already implemented.

To correct the problem, NSPA suggests that this Subcommittee include in a new taxpayer bill of rights a requirement that any notice of any type of examination or compliance check include a specific explanation of the affected individual's rights under that particular examination. If an examination is unannounced, those conducting the examination should have an affirmative duty to inform the taxpayer or practitioner of their rights before beginning the examination. The explanation of rights should specifically describe what a taxpayer or practitioner is required to show to the Service personnel. It should also tell taxpayers whether they are required to submit to the examination or not. If there is a right to refuse the examination, taxpayers should be informed of the consequences of refusal.

Before concluding, please permit me to point out that the issues raised here today are in no way intended to detract from the efforts of Commissioner of Internal Revenue Richardson and her

dedicated staff. They work tirelessly to administer the tax system in the United States, one of the most difficult and thankless jobs in the realm of public service. The National Society of Public Accountants hopes that the remedies sought here today will improve the current system, making it easier to administer and easing the burden on the Internal Revenue Service as well as the taxpayer.

VI. Conclusion

In closing, Madam Chairman, I would like to again thank you for the invitation to appear before the Subcommittee today. The National Society of Public Accountants applauds your leadership and that of the members of this Subcommittee in addressing the important issue of taxpayer rights. NSPA stands ready to assist you in your efforts in every way possible.

Respectfully submitted,

Dr. William Stevenson
Chairman of Federal Taxation
National Society of Public Accountants

Chairman JOHNSON. Thank you very much. Your testimony has been very helpful, and it is a pleasure to have those of you who are out there on the front line making good, constructive contributions and giving us the opportunity, through a number of different ideas that you have brought up today, to make the Tax Code not only more enforceable for the IRS but more user-friendly for the people affected.

I do want to ask a couple of things. First of all, I just want to put on the record that our current experience with political appointees isn't great, and I guess I personally take the view that Government, the legislative arm, used to be fairly bipartisan once the elections were over. And I think there is going to be a decade ahead when that is not going to be true.

I am not so keen as I used to be on solutions like ombudsmen confirmed by the Senate. I think you can see there have been some grossly unfair problems generated around nominees, and people's lives are being destroyed for no apparent reason. And I think this is going to mean for a time it may be hard for us to get good people who are willing to do this. So I guess at this point I would have to say that at least I am more interested in some other approaches and giving the system far greater guidance and exercising far more oversight.

I do think that perhaps if we were doing more aggressive oversight, we would catch some of these problems earlier.

I want to just ask your opinion, since we have such a good collection here in front of us. This issue of regulations is very difficult. It is very difficult for elected Representatives. You are out there, and people are saying, they gave us guidance, now that the regulations are out, they contradict their guidance, and they are making us liable retroactively, and that is not fair.

It seems to me that there are a lot of good reasons not to have laws go into effect until the regulations are prepared. First of all, I don't think you can really tell necessarily what the law is going to mean until you get regulations in place. For the IRS, that would be particularly difficult, and I understand that.

But I would like you to just comment on that. What has been in your experience the working relationship between guidance and regulations? Has the delay in the adoption of regulations been a problem? Or is the anecdotal evidence that tends to drive so much of an elected official's thinking not a major problem?

Anyone on the panel could volunteer.

Mr. Lane.

Mr. LANE. It is a serious problem. I mean, it literally is what created the tax shelter industry. You know, we had a very complicated series of laws passed, very close in time, generated a need for an incredible number of regulations to be issued. The time-lag between enactment and the regulations coming out caused the window of opportunity for unscrupulous people to go out and promote really baseless interpretations of what the law was going to do, and it created this environment.

I think that is a real problem, and it is going to continue to be a problem until we get this regulation thing squared away. One of the problems, quite frankly, is we have had what, 27 tax law changes in the last 29 years. You know, one of the best things the

Congress could do for this country would be to leave it all alone for a while. Quite frankly, it is a major complication for small business to try and keep on top of this stuff.

Chairman JOHNSON. You are stealing his theme. [Laughter.]

Well, there are a lot of ramifications to not letting a law become effective until the regulations are written, one of which is that you would get very different CBO estimates, and so it would make a big difference in actually how often we do change the tax code, because we would not get first year numbers of the same power. And I just want the others to have a chance to comment on whether it is worth the price that we will pay, and there are some significant prices if you do not let tax laws, particularly, go into effect until the regulations are written.

Any other comment?

Mr. THAYER. I would just like to kind of follow up. As you know, Congresswoman, we have just been debating, very avidly here on the Hill, and you have had input from us on this whole regulatory flexibility amendment act, and as you know, to get some teeth into the act, the 1980 Act, we called for the judicial review component of that.

I kind of go back to what has just been alluded to before. Obviously, from the business community, what our people are telling us, especially the smallest of small business, is that, you know, we are inundated now, and we really need you, just to leave us alone and let us do our business. But if you are going to regulate us, at least assess the impact of that regulation on our ability to do business as you have a law in effect, that says you are supposed to do that, before you put it into effect upon us.

And of course the number one perpetrator of not doing that has been the Internal Revenue Service, and that is why I represented the survey that I did in terms of my testimony.

Mr. JEROLD COHEN. Madam Chairman.

Chairman JOHNSON. Yes.

Mr. JEROLD COHEN. The regulations that are retroactive are interpreted regulations. They are not the substantive regulations. Substantive regulations must be prospective.

Chairman JOHNSON. What is the difference, though, from a taxpayer's point of view?

Mr. JEROLD COHEN. Well, from a taxpayer's point of view, the tax law is the law that you give us, that the Congress gives us, and there are many provisions of the code in which we have not been able to get regulations yet. What many of us are looking for from the regulations are some help in interpreting the provisions that the Congress has given us.

Now, to put in a requirement that the Service cannot make an interpretative regulation retroactive to the time Congress made that the law, leaves you with a real gap as to what the law is between——

Chairman JOHNSON. Mr. Cohen, I guess I wouldn't be recommending this as a policy governing past law made that doesn't have regulations, but only prospectively. That new tax law could not go into effect until——

Mr. JEROLD COHEN. That the law itself would not go into effect until——

Chairman JOHNSON. That is right. The law itself would not go into effect. First of all, it would force the Congress to want to write much simpler law, so that the regulations would be simple, so the whole thing would work.

Mr. JEROLD COHEN. I am totally in favor, and have written on the law being simpler, and also on the regs being simpler, and I think the Service is struggling with that now. I think that is an important measure.

But for the law not to go into effect until the regulation came out would put within the hands of the Treasury when a particular law goes into effect. And I don't think you would want to do that.

Chairman JOHNSON. Don't you think it would also force the Congress to write simpler law, and be clear about what it was they intended? And enable us to have shorter time frames?

Mr. JEROLD COHEN. I am not sure what forces the Congress to do anything. I have not been able to figure that out. Maybe another 30 or 40 years, that will come to me.

Ms. WALKER. But on the other side, it's Congress's responsibility to decide when that law is effective, and I don't think they should delegate that to the Treasury Department. We support the changes concerning the retroactivity of regs. However, in addition, the AICPA believes that by having these provisions the regs will get out sooner, and we think regulations in many cases are very, very important to efficient administration of the tax law.

Chairman JOHNSON. But aren't we delegating that authority anyway, because by the time they get the guidance out there, and then the interpretation of regs, the law is different than you thought it was, and so we have effectively delegated.

Ms. WALKER. Unfortunately, in today's world, which is much more complicated, you have delegated a lot more now than you did 20 years ago, and I don't know anybody that sees a way around that.

But to delegate the effective date, I——

Chairman JOHNSON. Well, let me yield to my colleagues here.

Mr. KEATING. Well, there is one other suggestion I might have on this. I don't know, procedurally, how you do this. If part of the problem is that the regulations don't reflect the law itself, maybe there could be a procedure that would require the regulations to be submitted to Congress, and for Congress to do some procedure to review them before they take affect.

Chairman JOHNSON. Well there is that process of regulations review in many States. Constitutionally, it has some difficulties, and I don't imagine that the Congress would adopt that. Also, I am not sure that any congressional committee would be up to evaluating whether the regulations were correct or not.

So I don't see that as a solution, but I am interested in this idea.

Mr. LANE. Could I add a comment here? One of the concerns we have as practitioners is we are dealing on a daily basis with taxpayers in our offices. We are trying to give them guidance as to how they can comply with the laws, and you know, the taxpayers have a brilliant way of really seeing through to the kernel of things sometimes.

And just by way of illustration, how this regulation thing can really get—and the tax law, the necessity for simplicity in the tax law. I am going to tell you a little story about a client I had.

Remember a couple of years ago, when we were going to enact a limitation on the amount you could deduct at a business meal, and it was going to be $25 per person? I had a client who did a tremendous amount of T&E entertaining.

And I said to him, you know, you really have to understand this. You know, I got him into my office, and I sat down, and I said, you really have to understand these rules because it really does affect you, particularly, because you do so much of this T&E.

And I started to explain this process, that no matter how much the bill is, it would be limited to the $25 or $35 per person. And after I got into about 15 minutes of explanation on this, he said, Wait a minute, I don't need to hear any more of this.

And I said, No, you have to understand this. He said, I don't need to hear any more of this. I said, Why not? And he said, Because I will wait till I get the bill before I figure out how many people were at the dinner. So what he was going to do, if the limitation was $25, and he had eight people at the table, and it was a $250 bill, he would put down he had 10 people at the table.

Now the taxpayers are going to look at this stuff. The point of that story is you can't set up regulations that are so complex, it breeds disrespect for the law.

Because when you do that, and they start to nickel and dime it on that stuff, before you know it they're not declaring major pieces of income they get.

Chairman JOHNSON. I guess part of my thinking is that if we could begin to see what the regulations are going to be, we ourselves might decide that that wasn't such a hot law, and fix it before it went into effect.

Mr. STEVENSON. I guess the bottom line is, maybe Congress does need to take another look at certain kinds of regulations, when it is brought to their attention that the regulations are not in keeping with the theme of the actual law, what their intention was.

Chairman JOHNSON. Let me recognize Mr. Hancock now.

Mr. HANCOCK. Frankly, I think it is a little ridiculous for Internal Revenue and their people to sit around thinking they can come up with something that is going to outsmart the people that are paying the taxes.

I mean, they are going to get outsmarted. They say it won't be dishonest or illegal. They will follow the plan.

One of the things that I would like to know—maybe you can answer this. In your estimation, does Internal Revenue get more money from people that do not take advantage of the deductions that they are entitled to, because they are afraid of Internal Revenue, than they have people that commit fraud, to try to cheat?

I realize it is strictly a speculation.

Mr. LANE. That is a tough one to answer because, you know, we don't know what the other side of it is. But I can tell you, there are very few people claiming the home office deduction——

Mr. HANCOCK. That are really entitled——

Mr. LANE. That are entitled to claim it, and are being told by their tax advisers not to run the red flag up. I can tell you that right now.

Mr. HANCOCK. But is this not true in a lot of other questionable areas, where they say, Well, you know, this would save me $300, but since it is a little bit of a gray area, I won't do it.

I mean, for instance, you mentioned the meals and entertainment deduction. I have had people say, Well, I have just quit deducting, even though I spent a lot of money for entertainment. I just don't deduct them anymore. A legitimate expense, but I don't want to take the chance.

I have even had people tell me, you know, I have got mileage. I just quit deducting my car mileage because I don't want to get involved with Internal Revenue. I fill out the 1040EZ form, if I can, rather than itemize.

I just wonder, you know, years ago, I remember my dad—his name was John Hancock, but not the one that signed the Declaration of Independence—but anyway, he made a comment that years ago that a person's No. 1 fear in many cases was a fear of dying. Now it is fear of the Internal Revenue Service. And I think you mentioned that. And I get this all the time, you know.

Mr. LANE. But you know, there is an old saying that there are two things in life that are always going to happen. That is death and taxes. But the punch line on that is that the death doesn't get worse every time Congress meets. That is the problem. [Laughter.]

Mr. KEATING. And death doesn't end your tax problems either.

Mr. HANCOCK. One of the taxes that I am worried about right now is the estate tax, which takes effect after I die. And, in fact, I think we are going to be addressing that on Monday.

You know, we have been talking all week about the rights of people on welfare. We talk about the rights of the criminal. We talk about minority rights. And I tell you, we have got to start talking about the rights of the people that are paying the bills for all of these things.

And if we don't—and I like Mr. Cohen's statement, I ran on the issue in 1988, that the best thing that could happen to really give this economy and this country the biggest boom that the world has ever seen, would be for the U.S. Congress to pass a moratorium on any change in the tax law for at least 5 years.

If we could get that job done, we would have the budget balanced a long time before the year 2002.

I have been up here 6 years, and I have been talking about it. Quite frankly, the problem is you have got too big a vested interest of people that benefit and make a living from changes in the tax law. I guess. Or maybe it's just a plain old lack of commonsense. I don't know what the answer is on it.

But Mr. Thayer, I am a small businessman. When I first ran for Congress, I knocked on a lot of doors and I remember one place in particular. A small businessman says, What are you doing for small business? And I said, What do you want done? He says, Nothing; leave us alone. [Laughter.]

And I think that is the message that we need to be sending and I hope we can do that over the next several months here on Ways and Means. So I have spoken my piece. Thank you.

Chairman JOHNSON. The gentleman from Ohio, Mr. Portman.

Mr. PORTMAN. Thank you, Mrs. Johnson. It is great having you all here. I wish we could stay here all afternoon and evening and talk about these issues because we have all these great minds, in small business, tax, and accounting, all together.

By the way, Mel, they are actually speaking against their own interest here, because they are talking about simplification and coming up with ways to end up with fewer, not more clients, which I appreciate from this panel.

Mr. HANCOCK. Well, that is right, but they understand what happens if we don't do it also.

Mr. PORTMAN. That is right; that is right.

Let me, just briefly, go back to some of the discussion about regulations, and the Chairman's idea, which I think is a very good one, of trying to tie the law, or the statute we passed here, more directly to regulations, so that we understand what we are doing.

We pass a law here and it is gone, we don't think about it again until enough of our constituents who are taxpayers come back in the case of the IRS, and complain to us about it, and we are shocked to find out what we have wrought.

But there is some precedent for this sort of a look back from Congress. The constitutional issue, as I understand it, is really more the delegation of powers. In other words, Congress is concerned, under the Constitution, rightfully so, about delegating our power to the Federal agencies.

And I think, in effect, we have done that over the years. But to have the agencies come back to us with proposed regulations, and have us, in essence, review them, and then approve them, I don't think would involve the same constitutional issues.

In fact in some sense it would solve existing constitutional problems of delegation of powers.

And just for those of you who don't know it, in this little unfunded mandate bill we just passed, we set in place a new procedure you might want to look at, whereby we have expedited procedures here in Congress to review Agency action down the line, after we pass a new mandate.

It is very complicated legislation. Our own Rules Committee had a lot of heartburn over it, and those of us who were promoting it on a policy basis are appreciative to them for letting us get it through.

But it handles some of the problems you are talking about, and does so in a way that permits the committees, like the Ways and Means Committee and the authorizing committees, to look at the regulations that come down the line after we act, and to decide whether or not those regulations are in keeping with what we have done, and if they are not we can change them, or we can simply rubberstamp them, approve them, and they will go ahead.

If we don't act, incidentally, which is the important incentive here, the regulations don't go forward. So there will be some incentive to actually review meaningful and important regulations, and perhaps to let die and to have the Agency start over again.

Second, I would say to Mr. Thayer that this same Act does provide, for the first time ever, judicial review of Agency action with regard to cost benefit analysis for the private sector regulations,

and of course, which is the focus of the legislation, local and State government regulations that we will be issuing in the future, that are mandates, without providing the funding.

So there is now some precedent to build on, I think, both to have judicial review of Agency action, including IRS action in the future, and to have some sort of a procedure for Congress to look at what we have wrought down the line.

But let me quickly get a couple of you into a dialogue, if I could, over one specific measure that is among the dozens that we have talked about today, and that is this whole notion of the new ombudsman or taxpayer advocate, and whether it should be an independent office, or not.

I talked to Senator Grassley, briefly, about it, whether a political appointee makes more sense, or an internal office, and I think Mr. Lane, you and Mr. Thayer, and perhaps Mr. Keating, have different notions of that.

I would like to hear the two or three of you speak about it. Maybe Mr. Thayer could start off, again, explaining why you think it is so important to have a political appointee in that position.

Mr. THAYER. Well, as we said to you earlier, we really believe that having a person in that position, responsible to Congress as opposed to being responsible to the Commissioner, relieves that person of a burden, obviously to account, and also gives at least the impression to the taxpayers—we would like to think more than that—that at least there will be a fair hearing, or a fair representation in terms of that office.

So we think it just remove that person, if you will, from being compromised in any way by the Office itself.

Mr. PORTMAN. Internal.

Mr. THAYER. That is right.

Mr. PORTMAN. And Mr. Lane, your concerns about that?

Mr. LANE. I guess our concerns are that the system in the field—where these cases happen—the district director is responsible for that district. The problem resolution officer reports to the district director.

So the district director has got a direct vested interest in resolving that case because he owns it.

And if the collection division is trying to levy on a taxpayer's wages, and problem resolution says they ought to not levy on it, the district director gets handed the decision. He owns the problem.

If you take the problem resolution function out from under that district director's jurisdiction, and now he is aligned with this national political appointee, I think you create a situation where the district directors can say, Well, you know, I don't have that problem, that is not my problem anymore, that is the ombudsman's problem, the taxpayer advocate's problem.

You know, if you are envisioning a taxpayer ombudsman, or a taxpayer advocate that is in the National Office, and that is the only one in the organization that is the political appointee, and everybody else still works for the district directors, then that situation might work very similar to the way you have chief counsel and the Commissioner appointed.

But I guess my reaction as a practitioner—and I deal with problem resolution probably three and four times a week—is that PRP is not broken. You don't need to fix it.

The testimony we got today: that ATAOs, went from 65 to 12, that, in Mr. Cardin's evaluation, could be looked upon as you are really having too restrictive a determination as to what qualifies for an ATAO.

But in the reality, what happens in the field, the stuff is getting resolved without having to go that far in the process. You bring it to their attention, and they are resolving it in some 80–85 percent of the cases.

I can tell you, I never had to go insisting that we get the ATAO. I have gone in with those situations, and it has been resolved.

Mr. PORTMAN. And partly being resolved because there is some accountability in the system to resolve it within——

Mr. LANE. Absolutely. It is in the district director's direct interest to get that issue resolved, so it doesn't turn into this case we heard about this morning with this poor woman from Texas.

Mr. PORTMAN. I think I have already run out of time, but Mr. Cohen, you are nodding your head regarding this. Do you have a similar story to tell with regard to your clients?

Mr. JEROLD COHEN. Yes, I do. I think it would be a mistake, and the Tax Section has been on record in this regard, to have a political appointee inserted within the Service. I really do think the system works as it is working now, and that the oversight of this subcommittee is the overall governing force to make certain that the system is working, and I think that it works best as it is presently set out.

Mr. KEATING. I would like to say something further about this. There is nothing in the bill that says the political appointee would change the current bureaucratic structure when problem resolution officers report to the district directors. Absolutely nothing. It is just independence of appointment.

Mr. PORTMAN. Yes, there is nothing that would necessarily say that all the taxpayer advocate local offices would report right up to the national office. But one thing that we found is that when there is a problem in the local office, it gets bumped, someone may go up to the National Office—it just gets bumped down. And in some cases, it just doesn't get resolved.

Mr. KEATING. The other problem is the IRS never comes in here to make substantial taxpayer rights recommendations. You can look at the IRS recommendations over the last 15 years. Every time there has been a bill, the Commissioner comes in, says no, we can't do this and we can't do that.

The fact is the installment agreement changes that have been made by the IRS and much of the positive things the IRS has done lately have come because of legislation introduced in the Congress. If we had a real taxpayer advocate, someone who comes from outside the Agency, who doesn't have to worry about where am I promoted after being a taxpayer advocate, would do a much better job, bring some fresh approaches, and actually come before this committee to say, Look, I know where the bodies are buried out there, I know where the taxpayers are being abused. I don't have to worry about my future with my buddies in the Agency.

Here are the problems that are out there, and these are my recommendations. We may even see some solid legislative recommendations. Now, we almost never get such recommendations from the IRS.

We get some trivial little things about interest abatements and whatnot, but that is shuffling deck chairs.

Jack Wade was in the bureaucracy in the IRS for many years. Maybe Jack could add a couple of comments about why he thinks this is very important. He has been in the bureaucracy, and I think he might have a couple of things to add on this point.

Mr. WADE. In one of my books, "When You Owe The IRS," I talked about the siege mentality inside the IRS, the sort of mission-minded mentality. The problem is that when you have been working for the IRS for 20 or 30 years, and the taxpayer ombudsman is typically somebody who has been around for that long, you tend to view things in a certain way. Often the attitude is, well, this is the way we have always done it, this is right, and anything else outside this, this is wrong.

We think that to be a true taxpayer advocate, you have to bring in somebody that has a fresh mind, somebody who is open to new ideas and new concepts.

People inside the IRS have known for a long time about the problem of the joint and several liability. They know the horror stories with spouses who get hit with tax liabilities caused by problems from their husbands—nobody has ever come up with a viable suggestion or solution from the IRS.

As David said, most of the suggestions that you get from the ombudsmen are very minor, such things as changing the Social Security number on the mailing labels. I think that is a good idea, but it is not a significant creative approach to solving some of the problems that need to be solved in dealing with taxpayers.

We are only looking for a way to bring in a fresh person with some fresh ideas, who can look at things a little bit more objectively.

The idea, for example, that you have user fees on taxpayers who need installment agreements, to me, is just absolutely abhorrent.

Now it is going to cost taxpayers, who can't pay their taxes, more money to pay their taxes in their installments. I think a true taxpayer advocate would have stepped in and said, This is not fair, this is violating the rights of the taxpayer, and this is something that we shouldn't be doing to people who are having difficulty paying their taxes.

There are a lot of instances like this, where we can cite, that these kinds of things should not be going on.

Now, we haven't really studied the idea of bringing the problem resolution officer in a direct line chain of command to the National Office, but when the ombudsman who talked here today—I kind of liked his approach of being involved in the selection process.

What we find in the field is that too many times there are a number of problem resolution officers who really do not have the guts to stand up to a functional division manager, such as a collection division or an audit manager, and say, This should not be happening.

Sometimes we found, and practitioners have reported to us, that the problem resolution officer bucks it back up to the division that started the problem in the first place.

The real problem is that the problem resolution officer, when he or she is done with that job, has to go back somewhere within the IRS to finish his or her career.

It is very unlikely, that somebody is going to stay a problem resolution officer for the whole length of their career. So they have to go back to their function, typically, where they came from—the Collection Division, or the Audit Division, or whatever.

So the problem resolution officer is not going to be butting too many heads, too many times.

So what we are looking at is a way to give the problem resolution officer some strength to be able to step in and issue a taxpayer assistance order, for example, if that is what it takes to get the job done.

We think that there needs to be some accountability here, and we need to find some way to strengthen that problem resolution officer so he, or she is not afraid of butting heads, if that is what it needs.

But in terms of taxpayer advocate, Mr. Thayer said it very eloquently. We don't believe that this is a job that is going to be held by a political hack.

We don't think that any of the Commissioners have been political hacks, nor any of the chief counselors who have held those jobs.

We think that the administrations, at least within the last 20 years, have held the IRS in high esteem. They have gone into the tax and accounting community and selected people with very impressive credentials.

If we ever found that this was going to be a dumping ground for a political hack, you can bet that we would be terribly upset and let you know.

We think that the IRS has been held in high enough esteem that a true political appointed ombudsman would also be someone of equal credentials.

Mr. PORTMAN. Thank you, Mr. Wade, and I think all the panelists, Ms. Walker, or Dr. Stevenson, may have additional comments. Madam Chairman, do we have time?

Chairman JOHNSON. Yes, absolutely.

Ms. WALKER. Let me just be real quick.

The AICPA is on record as stating that we don't believe it should be a political appointee, that it works best, the system that is in place now, as part of the overall Internal Revenue Service.

And in listening to all of this, I guess I would just say why isn't all this part of the Internal Revenue Commissioner's job, as being, you know, a friendly place collecting revenues for the Government as opposed to an adversarial relationship?

I mean, I would put it right at that level.

Mr. PORTMAN. Dr. Stevenson, do you have any comment?

Mr. STEVENSON. Very briefly. As a student of the administrative processes—that is what my doctorate is in—I think, in balance, the system that is in place at the local level has problems in various districts, but on a broad-brush stroke, as Joe said, it's not really broken.

However, there is one problem that we do meet with the Internal Revenue Service officials several times a year—and we bring this community that is sitting here—we bring advocacy issues to the Commissioner and the Commissioner's staff, and various other people.

They listen to us, but we're not really sure that they hear us. Now, when we come and speak to you about certain issues, I get the impression that you are listening and hearing.

So maybe, in balance, with the use of oversight for taxpayer advocacy, plus the work that we are doing at the ground roots level, may help the system along a bit.

Mr. PORTMAN. Thanks very much. I would just make one final comment, and that is, given all the testimony we have heard today, and particularly from this panel, that you all represent many powerful groups' interests out there in the tax community. I would hope that you all work with us toward simplification over time.

Because I think when you get right down to it, a lot of the concerns we have raised here are solved not so much by tweaking the code, or changing the administrative process, and so on, but by just simplifying the code and making it clear, not within the parameters of having to figure out what income has risen, if it is an income tax, but trying to make clear what the actual taxpayer responsibilities are, and clear what the IRS responsibilities are, to avoid a lot of these problems.

So I would hope you will stick with us, and work with us closely. I know that, again, as I said, initially, many of you, frankly, among your constituencies, will have conflicts of interest on that very issue. Because the more we simplify it in some senses, the fewer accountants and lawyers, and other tax advocates that one would need.

Mr. LANE. Mr. Portman, don't be concerned at all. Everybody at this table, I am certain, would be favor of tax simplification, even though it might cost us a couple of clients.

Because no one is more beleaguered by all the changes than the people that are in the business, that are constantly having to explain the changes.

I mean, if you had to sit down with a client that had a business car, he put in business use in 1982, and changed in 1984, 1986, 1988, and 1990, you would have some sense of the frustration we feel. There literally was a law change every other year in that category. A different way of treating the depreciation——

Chairman JOHNSON. Let me recognize Mr. Hancock.

Mr. HANCOCK. Yes. I think we are dealing with seven different depreciation schedules now in our company, and I will frankly admit, I don't think anybody can say absolutely, 100 percent, that we are accurate on it. But I mean, we do the best we can.

You know, maybe the solution would be to come up with a psychological examination for people that are going to go to work for the Internal Revenue Service and find out whether they are Socialist or Capitalist. [Laughter.]

Mr. HANCOCK. And then we can make them split it up anyway. Right now, I am wondering if we haven't got about 75 percent of them over there that believe in redistribution of the wealth. Thank you.

Chairman JOHNSON. Well, I would urge you to reflect on the comments that have been made on this panel.

You have pointed to some of the things that we have done together that, by people bringing recommendations to us, and our changing the law, we have accomplished.

I am not so sure that is not the best ombudsman, and maybe it is that we underutilize that oversight capability, and the ability to change the law, because we have traditionally hooked our ability to make those moves from this committee into the macro tax bills.

We are going to try to change that this session. I have the Chairman's backing in that. I am working with the Senators on that. We are going to try to see if we can't do small things that need to be done, just to fix up and clean up, and make more equitable the process, independently, and not as part of macro bills.

But the achievements you point to are ones that we heard testimony on and legislated on. I frankly have more confidence in that process than the process of a political appointee.

And you say if they became political, you would be the first to want to change it. It is very hard to change it, to get it in place, and what I am saying to you is, you really believe this should be a political appointee. That you need to think through and give me an example of where, in Government, that has really worked.

Because I have been a part of passing a lot of legislation that appointed czars for this, czars for that, overseers for this, and ombudsmen for that, and I don't know one, that after a few years, made any bit of difference, but it sure did increase the complexity.

And I am very concerned about the on-the-line front office, where one person has a different agenda than anybody else, and possibly a hostile agenda.

Their agenda may be to embarrass the people they worked with, because that is the agenda of their appointee, to show how important they are, how valuable they are, how you couldn't do without them, because look at all the awful stuff that is going on.

So don't believe that's not a real danger. It wouldn't be the first appointee. But we're talking about decades; we're not talking about weeks.

So if you want us to go down the path of a political appointee, you will have to prove to at least the chairman of this committee, that it has worked somewhere, at some time, for a decade.

I leave you with that challenge, and thank you for your input. I hope that you will work with us through this process, because it is apparent from this hearing that we could actually be doing a lot of interesting things that would work to make the administration of the code function more equitably, and I think that is our shared interest.

Thank you for being here, thank you for your patience in this day-long effort, and I look forward to working with you.

The hearing is adjourned.

[Whereupon, at 3:32 p.m. the hearing was adjourned, subject to the call of the Chair.]

[Submissions to the record follow:]

STATEMENT OF ERNEST J. DRONENBURG, JR.
VICE CHAIRMAN
CALIFORNIA BOARD OF EQUALIZATION
SUBMITTED TO THE OVERSIGHT SUBCOMMITTEE
OF THE HOUSE WAYS AND MEANS COMMITTEE

April 3, 1995

Many members are familiar with my record on taxpayer rights. I strongly supported the Taxpayer Bill of Rights 1 and have been a consistent advocate for protecting taxpayers from abusive tax enforcement practices. However, the purpose of this statement is to express my strong opposition to legislation, H.R. 390, sponsored by Representative James Traficant, that would shift the burden of proof from the taxpayer to the IRS for tax cases. This legislation would have far-ranging and negative consequences on not only the Internal Revenue Service, but also on State tax systems and honest taxpayers across the country.

I am an elected member of the California Board of Equalization. The Board of Equalization is California's major revenue agency and is responsible for the administration of State and local tax programs. The five member Board was created by California's Constitution in 1879 with four members elected from districts and the State Controller serving as the fifth member.

The Board of Equalization administers State and local sales and use taxes, motor vehicle fuels license taxes, and the cigarette tax. The Board also serves as the body which hears tax appeals. The Board of Equalization is also responsible for appraising all the properties of privately owned public utilities and railroad companies for local property tax purposes. H.R. 390 would severely cripple the ability of the Board of Equalization to meet its constitutional obligation to administer and enforce our State's tax laws and would likely amount to an enormous burden on honest taxpayers by protecting tax cheaters.

IMPACT ON VOLUNTARY COMPLIANCE

Both Federal and State tax systems depend on the voluntary compliance of taxpayers to fulfill their tax obligations and properly report their taxable income. We are very fortunate that the current system operates in a way that results in a high level of tax compliance. A key element to this success is that taxpayers understand it is their obligation to document their taxable income, their credits and deductions, be it a receipt from the Salvation Army for a charitable donation or a mortgage interest statement from their lending institution. The commonly accepted practice over the years has been that the party with the access to the evidence

should bear the burden of providing that evidence. It would be a radical departure to suddenly change the rules and say the tax agency must provide the documentation without full and careful consideration of the consequences.

A purported reason for this legislation is that taxpayers fear the IRS and this bill will lessen that fear. However, I contend the practical effect of this bill would be much different. Rather than allowing the taxpayer to provide the necessary documents to prove their case, it would require that tax auditors get that information from any source available, which could very easily involve interviewing neighbors, employers, other family members -- exposing alleged tax violations to a taxpayer's friends, family, co-workers and community. Imagine going to church one Sunday and having the minister tell you about a visit from an inquiring tax auditor -- how would you feel? Consequently, this proposal could prove incredibly intrusive on one's privacy and rather than being a contained matter between the IRS and the taxpayer, could instead escalate into a very public dispute involving anyone a taxpayer knows who could shed light on their taxable income.

If this burden of proof is moved from taxpayer to tax agency, it would, over time, encourage a disregard for compliance by those taxpayers intent on underreporting their income, because it is obviously easier for the taxpayer to not disclose information than it is for tax auditors to track it down. It is difficult to measure what would be the actual extent of the decline in taxpayer compliance -- but I am confident it would be significant and would increase as time passed.

Naturally, this errant behavior would spill over into noncompliance with State tax systems too. Thus, both Federal and State revenue systems can expect a dramatic drop in tax revenues due to increased noncompliance by Federal and State taxpayers. If Federal and State governments are forced to fill the revenue gap by increasing taxes, then noncompliance would increase even more because there would be even stronger incentives not to comply -- thus creating a vicious cycle of higher taxes to bring in adequate revenues, and falling compliance to avoid an ever-increasing tax liability.

INCREASE DEMAND ON IRS WILL HARM INFORMATION SHARING WITH STATES

State tax systems rely on the Federal tax audit program for assistance in identifying nonfilers and or other taxpayer deficiencies. If H.R. 390 is enacted, the IRS and others justifiably contend that their audit resources will be strained to the limit. Under the current system, the IRS audits approximately 1% of taxpayers annually. If the IRS must assume the burden of proof responsibility, two changes will occur. First, for the current level of audits, the paperwork demands would increase because it would fall to the IRS to collect the necessary documents to prove their claims against noncomplying taxpayers. Second, if the rate of

noncompliance jumps as tax officials expect, more resources will be needed for the higher case load. What does this mean for State tax systems? States often piggyback on deficiency assessments made by the IRS -- so any delays or backlog by the IRS trickles down to the States as well. Thus, States will have inadequate information to conduct their tax audits.

BURDEN OF PROOF COULD BE IMPOSED ON STATE TAX SYSTEMS

If H.R. 390 were enacted, State governments could soon expect similar legislative efforts in their respective legislatures. California is one of the States that conforms to the Federal tax system in many areas. If the burden of proof is shifted for Federal taxpayers, that new standard could potentially be adopted by the California Legislature. In that case, we would have a double hit of contending with the consequences of the burden of proof shift at the Federal level and at the State level.

During these times of extreme fiscal stress on government revenues, State Legislatures would be hard pressed to provide the additional funding to tax agencies to fully comply with the new demands of shouldering the burden of proof responsibilities. While implications for the rights of taxpayers is more troubling, the fiscal realities also make it clear to me that this bill is poison in a pretty wrapper.

UNDERMINE ENTIRE TAX SYSTEM

This proposal runs contrary to efforts by the IRS and by State tax systems to become more service-oriented, more accessible, and more cooperative in dealing with taxpayers and with sharing information among tax systems. Our current tax compliance system has a strong foundation of fairness and efficiency that in turn has created mutual respect for the system and for our taxpayers -- the high rate of compliance is evidence that this system works.

If instead, our resources are devoted to compiling evidence on every dispute like it was a criminal investigation, tax collectors would indeed become the "tax gestapo." I ask that you not let the tremendous progress we have made in improving our tax system backslide due to some misplaced understanding of what are appropriate procedures in handling tax disputes. Please oppose the advancement of H.R. 390. Thank you.

TESTIMONY OF HARLEY DUNCAN
FEDERATION OF TAX ADMINISTRATORS

The Federation of Tax Administrators is an association of the primary tax collection agencies in the 50 states, the District of Columbia and New York City. FTA is concerned that the far-reaching effects of H.R. 390 may not be fully understood. Specifically, we would ask the Subcommittee to consider the bill's deleterious effect on the states' ability to collect taxes.

On the surface, H.R. 390 applies only to the Internal Revenue Service. In simple terms, it would place the "burden of proof" on the IRS rather than on a taxpayer in civil matters. This is generally viewed as a Taxpayer Bill of Rights issue. While taxpayer rights are crucial and should be respected, they must also be balanced against the ability of government to effectively collect the revenues due it. Taxpayer burden of proof is a key element in that process.

Shifting the burden of proof from the taxpayer to the federal government would seriously undermine the federal income tax system. It would make it virtually impossible to assert deficiency assessments for all federal taxes. It will establish a legal system that allows taxpayers to underreport taxes, but not be required to produce information to support their tax reporting. The problem is most easily explained in the following example: an individual deducts $3,000 in charitable contributions, but has no receipts to back up the claim. The government would have to prove this was not true – and it is impossible to prove a negative.

Over time, the bill would destroy voluntary compliance. Taxpayers will quickly learn that they have little reason to report their taxes accurately, and that if they are inaccurate, IRS has little or no legal ability to prove they are wrong. In other countries where the government has the burden of proof, voluntary compliance is an exception, never the rule. In the U.S., some 85 to 90 percent of all dollars are voluntarily paid in full and on time without the federal or state governments having to undertake individualized enforcement actions.

If H.R. 390 is enacted, it would affect each of the states in three ways:

- Many state audit programs – particularly those relating to the individual income tax – rely heavily on the federal programs. When the federal government discovers a nonfiler or finds that an individual has underreported the federal tax due, IRS automatically notifies the state tax authorities. Similarly, states and the federal government are working very closely together to discover unpaid tax on motor fuels. This is modern and efficient government; it also allows states to reap the benefits of far more compliance activities than they could otherwise afford. However, if IRS is no longer able to effectively make deficiency assessments, the states will lose this critical compliance mechanism.

- The provision's harmful effect on voluntary compliance will directly flow through to states. When voluntary compliance drops at the federal level, it most certainly will drop at the state level. This will be especially true if the states have lost their most effective enforcement tool, piggybacking on IRS deficiencies.

- State legislatures often follow the Congressional lead, particularly on Bill of Rights issues. If Congress puts its stamp of approval on this concept, public pressure will be great for the state legislature to follow suit.

I urge you to consider these frightening consequences to the states if H.R. 390 is passed.

Harley Duncan
Executive Director
Federation of Tax Administrators
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TESTIMONY OF RUSSELL A. HOLLRAH
INDEPENDENT CONTRACTOR ASSOCIATION OF AMERICA, INC.

The Independent Contractor Association of America, Inc. (the "ICAA") is a national association — representing over 2700 businesses that engage, or operate as, independent contractors — that is dedicated to the preservation of independent contractor status.

ICAA strongly supports efforts to enhance the rights of taxpayers vis a vis the Internal Revenue Service ("IRS"). In worker classification disputes, the taxpayer is at a serious disadvantage relative to the IRS, and the IRS routinely engages in enforcement strategies that exploit its advantage. Small business taxpayers that engage independent contractors are currently suffering under the weight of an aggressive IRS enforcement program aimed at reclassifying such workers to employee status.[1]

In order to counteract the IRS's enforcement practices that relate to worker classification matters,[2] ICAA strongly supports the Taxpayer Bill of Rights proposals generally, and especially supports the proposals that would make it more feasible for taxpayers to recover the fees and costs incurred in prevailing against the IRS in a federal tax dispute. ICAA also urges that the Subcommittee consider additional taxpayer rights provisions that deal specifically with the IRS's attack on businesses that use independent contractors:

- ICAA urges that a taxpayer be deemed eligible *per se* to recover the fees and costs incurred in defending against an IRS challenge to the taxpayer's classification of a worker as an independent contractor if the taxpayer is ultimately determined eligible for protection under Section 530 of the Revenue Act of 1978 ("Section 530"), based on the taxpayer's reasonable reliance on a safe haven that the taxpayer asserted during the IRS's administrative consideration of the issue;

- ICAA urges that any IRS review of a taxpayer's classification of workers be deemed an "audit" for purposes of Section 530, irrespective of how the IRS characterizes the review; and

- ICAA urges that the IRS be prohibited from targeting small businesses for intensified enforcement efforts seeking the reclassification of independent contractors, as the IRS currently does through its Employment Tax Examination Program ("ETEP").

The Standard that a Taxpayer Must Satisfy In Order to Recover Fees and Costs Incurred in Winning a Tax Dispute Should be Relaxed.

Under current law, a taxpayer is not entitled to recover attorney fees or costs in an IRS dispute unless it can demonstrate, among other things, that the government's position was "not substantially justified."[3] The interpretation of the fee and cost recovery provisions has been overly strict. The statistics offered by the American Bar Association confirms the fact. The ABA testimony pointed out that while the provisions were "scored" as producing a revenue loss each year of $5 million, the actual aggregate awards under the provisions each year have been a mere $220,000. The data leave no doubt that the provisions are not working as the Congress had intended.

ICAA concurs with the witnesses who testified before the Subcommittee that the problem lies with the requirement that a taxpayer prove that the government's position was not substantially justified.[4] In order to remove that impediment, ICAA supports the proposals

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[1] The IRS's bias against independent contractor status is manifest. The bias has been proven to exist through quantitative analysis in Robinson and Hulen, *IRS Bias In Worker Classification Decisions*, Tax Notes 1741 (September 26, 1994).

[2] While ICAA supports the Taxpayer Bill of Rights provisions generally, ICAA is dedicated exclusively to the preservation of independent contractor status and, therefore, the comments contained herein are limited to the provisions that relate to those specific interests.

[3] Internal Revenue Code section 7430.

to shift the burden of proof to the government, so that instead of requiring the taxpayer to demonstrate that the government's position *was not substantially justified*, the government should be required to demonstrate that its position *was substantially justified*. This does not appear to be an onerous measure, particularly inasmuch as the IRS General Counsel testified at the hearing that government lawyers currently prepare for fee and cost recovery cases by assembling the evidence necessary to demonstrate that the government's position in the case was substantially justified.

ICAA also would support the proposal that would simply eliminate the requirement altogether, so that the issue of whether the government's position was reasonably justified is no longer relevant.

With respect to the cost and fee recovery provisions, the important point is that current law is inadequate. ICAA takes no position as to whether the inadequacies are better addressed by eliminating the need to determine whether the government's position was substantially justified, or by shifting the burden of proof on that issue from the taxpayer to the government. ICAA believes that either would represent a long stride in the correct direction and, therefore, supports both proposals.

Taxpayers Should be Deemed Eligible *Per Se* to Recover Fees and Costs Incurred in Winning a Worker Classification Dispute When the IRS Refuses to Acknowledge the Taxpayer's Section 530 Protection.

The IRS, when challenging the classification of workers by a small business, frequently provides the business with a Hobson's choice of either defending its classification of workers as independent contractors in court — and jeopardizing the financial viability of the business even if it prevails — or acquiescing to the IRS's demand that it reclassify the affected workers to employee status.

While a legal battle can be financially devastating to a small business, a reclassification can have severe financial consequences as well. Many businesses that have acquiesced to an IRS-demanded reclassification of independent contractors have found that their best workers refuse to work as employees and cease performing services for the business.

The Congress during 1978 sought to tame the IRS's aggressive attacks on businesses that engage independent contractors by enacting Section 530 of the Revenue Act of 1978. Section 530 was intended to protect a taxpayer that satisfies the Section 530 criteria against the IRS reclassifying its workers to employee status. The Congress expressly instructed that Section 530 is to be liberally construed *in favor of the taxpayer*.[5] In practice, however, the IRS construes Section 530 narrowly, *against the taxpayer*.

In other cases, particularly in the context of an IRS Form SS-8 request,[6] the IRS commonly refuses to even consider Section 530. In such cases, a firm eligible for Section 530 protection that responds to the Form SS-8 request is forced into a confrontation with the IRS over the application of the common law test to its workers — a controversy that the Congress sought to avoid by the enactment of Section 530.[7]

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[4] An example of a case were a taxpayer who appeared clearly entitled to recover fees and costs in an independent contractor dispute but who was denied recovery on the grounds that it failed to demonstrate that the government's position was not substantially justified was *In re Rasbury*, 93-1 U.S.T.C. ¶50,351 (N.D. Ala. 1993) *affirmed* 94-2 U.S.T.C. ¶50,319 (11th Cir. 1994).

[5] *General Investment Corp. v. United States*, 823 F.2d 337, 340 (9th Cir. 1987).

[6] The Form SS-8 is used by the IRS for soliciting facts from a firm and a worker for purposes of ascertaining whether the firm's classification of the worker as an independent contractor is proper.

[7] In *Queensgate Dental Family Practice, Inc. v. United States, 91-2 U.S.T.C.* ¶ 50,536 (M.D. Pa. 1991), the district court observed that the Congress made clear that a business that

ICAA suggests that the IRS's enforcement posture with respect to Section 530 would become more moderate if the fee and cost recovery provisions were modified to provide that if a taxpayer advises the IRS of its eligibility for Section 530, the taxpayer will be entitled *per se* to recover fees and costs incurred in winning its case. The recovery could be made contingent on the taxpayer ultimately being determined eligible for Section 530 based on a safe haven provision that the taxpayer relied on when asserting Section 530 protection during an IRS administrative proceeding.

Any IRS Review of a Taxpayer's Classification of Workers Should be Deemed an "Audit" for Purposes of Section 530, Irrespective of how the IRS Characterizes the Review.

Another means used by the IRS to undermine Section 530 is to seek to review a taxpayer's classification of workers without the review being considered an "audit" — in order to avoid the taxpayer qualifying for Section 530 protection based on the prior audit safe haven. The IRS frequently seeks to characterize such reviews as "compliance checks."

A primary objective of Section 530 was to protect taxpayers against recurring IRS audits concerning the classification of workers as independent contractors. To permit the IRS to accomplish a review of a taxpayer's classification of workers as independent contractors through "compliance checks" — without the review establishing a basis for Section 530 protection against subsequent similar reviews — would defeat much of what Section 530 sought to accomplish.

What is more, if the IRS is allowed to continue its current practice of reviewing a taxpayer's classification of workers as independent contractors through compliance checks, without triggering Section 530 protection for the taxpayer, the IRS will have succeeded in accomplishing a *de facto* administrative repeal of the prior audit safe haven of Section 530.

ICAA respectfully urges, therefore, that the Congress clarify that an IRS review of a taxpayer's classification of workers as independent contractors constitutes an audit.

The IRS Should Be Prohibited from Targeting Small Businesses for Intensified Enforcement Actions Involving Independent Contractors, as it Currently Does Through the ETEP.

The IRS has aggressively pursued small businesses that engage independent contractors in an effort to reclassify such workers as employees. The pursuit is attributable largely to the high-profile "Employment Tax Examination Program" that the IRS launched in 1988, known by the acronym "ETEP." The program unabashedly targets businesses with $3 million or less in assets for an intensive worker classification enforcement effort.[8]

The ETEP is patently discriminatory against small businesses. A common characteristic of many small businesses — which makes the program particularly inadvisable — is that such businesses typically do not possess the resources needed to aggressively defend against IRS efforts to reclassify workers as independent contractors.

Anecdotal evidence of IRS representatives pressing taxpayers into reclassifying workers to employee status on a prospective basis (known as the IRS's "prospective compliance" offer) — in cases where the taxpayer may well have prevailed if the matter was defended on its merits — abounds. As a matter of fact, there are legions of small business

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satisfied the requirements of Section 530 need not also be analyzed under the common law test.

[8] For further discussion of the ETEP, see *The Administration and Enforcement of Employment Taxes — A Status Report on Ideas for Change*, H. Rep. No. 861, 103rd Cong. 2d. Sess (October 19, 1994).

owners who have capitulated to the IRS's prospective compliance gambit — based on the IRS's overstated estimates of the how much it would cost the taxpayer to contest the matter — only to subsequently feel as though they had been tricked by their own government into the reclassification.

While there is no question that the IRS has the right to enforce the tax laws, ICAA contends that the IRS's enforcement efforts must be evenly applied, and that it is not appropriate for the IRS to focus its efforts on a category of taxpayers who are least financially able to defend themselves. What is more, the inappropriateness of such an enforcement strategy is compounded where the IRS unabashedly seeks to exploit the taxpayers' vulnerability, by aggressively urging them to settle the cases — without regard to the merits of the case — on the grounds that the expense involved in defending their position would be cost-prohibitive.

In light of the foregoing, ICAA respectfully urges the Congress to prohibit the IRS from focusing its worker classification enforcement efforts on small businesses and, in so doing, to require the IRS to terminate the ETEP.

Conclusion.

ICAA appreciates the opportunity to present this statement. While TBR 1 represents significant progress in the enhancement of taxpayer rights, much more needs to be done, particularly with respect to the manner in which the IRS currently administers the tax laws that relate to a worker's status. If you have any questions or would like additional information concerning any of the foregoing comments, please let us know.

Respectfully submitted,

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TESTIMONY OF ROBERT M. TOBIAS
NATIONAL TREASURY EMPLOYEES UNION

Madam Chairwoman and distinguished Members of this Subcommittee. Thank you for the opportunity to submit this statement concerning taxpayer rights. As President of the National Treasury Employees Union (NTEU), which is the exclusive representative of employees from the Internal Revenue Service, we have a particular interest in the taxpayer rights issue. NTEU strongly endorses the concept of defining and protecting taxpayer rights, however, we are wary of creating a system which does not accomplish the goals and paralyzes IRS, rendering them unable to properly carry out their mission to collect taxes.

During the March 24, 1995, Ways and Means Committee, Oversight Subcommittee hearing, Congressman Andy Jacobs (D-IN) testified in support of a proposal to make IRS employees personally liable for "arbitrary, capricious or malicious" acts committed while performing their job duties. NTEU is vehemently opposed to this concept. As you may or may not know, the issue of holding IRS employees personally liable for "arbitrary, capricious or malicious" acts was considered and rejected by the 102nd Congress in the context of a major tax bill, H.R. 11. I am attaching for the record a copy of a letter, signed during H.R. 11, by eight former IRS Commissioners opposing the personal liability provision. In addition, the American Bar Association's Tax Section has publicly opposed this provision.

The reason for such widespread opposition is not difficult to imagine. Not only would the Jacobs proposal make it virtually impossible to recruit and retain IRS employees, it would also undermine the ability of any IRS employees, who were willing to stay in the IRS, to properly collect taxes. While we believe that most Americans are law abiding, compliant taxpayers, we also know that there are people who use the system to avoid paying taxes and others who would not pay taxes if they believed they could get away with it. IRS employees must deal with these noncompliant taxpayers every day. A noncompliant taxpayer would have every incentive to threaten suit against an employee when that employee sought to bring the taxpayer into compliance. The natural result of such a relationship is for the IRS employees to be unwilling to deal effectively with aggressive taxpayers for fear of personal liability. Ultimately, the government would collect far less revenue.

It would become virtually impossible for IRS employees to effectively collect taxes with the black cloud of personal liability hanging over their heads. It is unclear what acts under the Jacobs proposal would be considered "arbitrary, capricious or malicious" and therefore subjecting employees to personal liability. One Judge could find an IRS employee's actions totally reasonable while another Judge could find the *same* actions "arbitrary and capricious". The IRS employee, in an attempt to avoid liability, would constantly be second guessing his/her actions. It will be impossible for an IRS employee to know if his/her actions fall within an "arbitrary and capricious" category. This unworkable standard will result in a chilling effect on the employee's ability to collect taxes.

Not only would personal liability for IRS employees result in less effective tax collection, it would also subject IRS employees to constant harassment. In an effort to avoid IRS action, the noncompliant taxpayer would use every opportunity to raise the personal liability threat against the IRS employee. As the IRS employee found it necessary to increase his or her efforts to bring a taxpayer into compliance, the taxpayer would escalate the threat of personal liability against the employee. Ultimately, it would be the IRS employee who would be harassed by the taxpayer.

We do not approve of inappropriate actions by IRS employees or other federal employees. However, we firmly believe that taxpayers have appropriate recourse in such a circumstance. Aggrieved taxpayers may bring actions against the government for attorney fees and there are currently legislative proposals to increase the possible recovered amount from $100,000 to $1 million. We do not oppose these legislative proposals but we strongly oppose workers

who will risk losing the homes and their kids' college savings every time someone who doesn't want to pay his/her taxes charges them with acting in an undefined "arbitrary" manner.

There is not one group of federal employees who are held personally liable for non-criminal acts if they are acting within the scope of their work duties. Rather, the employer is the liable party. The proposal being set forth by Congressman Jacobs would treat IRS employees differently from all other federal employees, by subjecting them to personal liability. This would make recruiting people to do the unpleasant, but necessary job of collecting taxes set by Congress virtually impossible.

We would also like to remind this Committee that stiff penalties exist, including removal, for inappropriate actions by IRS employees. But, we believe that the dual goals of protecting taxpayers and collecting taxes can be achieved by enforcing existing rules against employees and continuing to allow or expand suits against the government. Requiring the personal liability of IRS employees will make it impossible to find qualified people willing to do the job Congress has directed them to do: collect taxes.

In closing I would like to say that NTEU is very willing to work with Congress and IRS employees to ensure that taxpayers are being fairly treated and at the same time revenue due is being collected in the most effective and productive manner. Thank you for allowing me to submit this statement for the record.

July 15, 1992

The Honorable Dan Rostenkowski
Chair, House Ways and Means Committee
House of Representatives
Rayburn 2111
Washington, DC 20515

The Honorable Lloyd Bentsen
Chair, Senate Finance Committee
United States Senate
Hart 703
Washington, DC 20510

Dear Sirs:

As former Commissioners of Internal Revenue for the past thirty years, we express our concern and strong opposition to certain provisions contained in Title V of H.R. 11 which we believe would seriously and adversely affect tax administration.

Each of us has worked with you or your predecessors in attempting to assure that the Internal Revenue Service ("Service") met its obligation to fully and fairly collect the proper amount of tax owed to the Federal government. In addition, each of us has represented taxpayers in dealing with the Service before and/or after serving as Commissioner. We therefore recognize, as we know you do, the difficulties that the Service faces in collecting the amount of tax properly owed and at the same time doing so in a fair, even-handed and professional manner.

We take seriously the importance of balancing the authorities needed by the Service to discharge its obligations with the rights of individual taxpayers in their dealings with the Service. You well know, and we recognize, that such balancing of the authority needed by the Service to properly perform its duties with the rights of individual taxpayers is often as difficult as it is important. And this is particularly true at the present time in light of the government's need for revenue, the complexity of our Federal tax laws, and the increasing lack of confidence and respect of our citizenry in governmental authority.

In view of these competing considerations, we have considered carefully the provisions of Title V of H.R. 11. Some of the provisions may be helpful, but we have substantial concerns about the impact of other provisions on our Federal tax system. There are three provisions that we feel so strongly about for the reasons indicated below that we urge you to reconsider and delete them from the legislation that you presently are considering.

1. Personal Liability of Service Employees. Section 5704 of H.R. 11 would impose personal liability on Service employees in certain circumstances. Presently, if a taxpayer is the "prevailing party" in tax litigation, then under certain circumstances a court can require the Federal government to reimburse the taxpayer for certain litigation costs. Under the pending proposal, the court could require a Service employee personally to reimburse such costs if the court determined that the proceeding resulted from any arbitrary, capricious or malicious act of the employee, and, in such event, the employee would not be permitted to recover such costs from the Federal government.

This proposal has been criticized publicly by the Taxation Section of the American Bar Association and the Tax Section of the New York State Bar Association. We concur with their criticisms and opposition.

We do not condone the arbitrary, capricious or malicious actions by Service employees in dealing with taxpayers. We believe, however, that present law and procedures provide an aggrieved taxpayer with substantial remedies to redress such conduct, including the Service's Office of the Taxpayer Ombudsman, the Problem Resolution Program, and the Office of the Chief Inspector, as well as the Treasury Department's Inspector General and the provisions of Section 7433 of the Code permitting a taxpayer to bring a civil action against the United States for damages sustained in connection with the collection of Federal tax due to the reckless or intentional disregard of Federal law by a Service employee. Likewise, there are substantial and serious disciplinary measures available to properly punish any employee who might engage in such unauthorized behavior.

Our collective experience in the public and private sectors suggests that although there are instances of inappropriate conduct by Service employees, they tend to be relatively isolated and unusual. It is further our collective experience that although most taxpayers make an honest attempt to cooperate with Service employees in determining their tax obligations, over the last thirty years we also have seen increasingly aggressive behavior by some taxpayers in dealing with Service employees, including a limited but significant number of instances in which certain taxpayers intentionally harassed or attempted to intimidate Service employees. IRS examination, collection and enforcement activities are inherently adversarial in nature; and, in such context, we submit that it may be difficult to delineate adversarial conduct from arbitrary, capricious and malicious behavior.

We believe that the proposal is unwise. We believe that it is likely to cause Service employees to be less willing to deal effectively with uncooperative, aggressive taxpayers because of the employees' concern about potential harassment and possible personal liability in such event. We further believe that such concerns will adversely impact upon the Service's ability to recruit and retain compliance personnel. As you know, similar concerns traditionally have resulted in the grant of general immunity to Federal employees acting in their official capacities.

It is, therefore, our judgment that in balancing the authority needed by Service employees with the rights of individual taxpayers, this proposal is inappropriate and should be rejected, and we urge you to do so.

2. Political Appointment of Ombudsman. Presently, there is a Taxpayer Ombudsman on the staff of the Commissioner of Internal Revenue who is appointed by the Commissioner and who oversees the Service's Problem Resolution Program ("PRP"). Section 5001 of H.R. 11 would replace the Ombudsman with a "Taxpayer Advocate" who would be appointed by the President and confirmed by the Senate and who would supervise all of the PRP personnel.

As you may know, the idea of an Ombudsman was developed by Commissioners Alexander and Kurtz. Most of the undersigned, therefore, have worked directly with the Ombudsman and PRP and all of us enthusiastically support the goals and activities of the Ombudsman and PRP. Each of us believes that the pending proposal is likely to substantially and adversely affect the goals and activities of the Ombudsman and PRP programs, and we therefore oppose the proposal.

Our collective experience indicates that the role and importance of the Ombudsman and PRP programs are increasing. We believe that among the keys to the continued effectiveness of these programs is the need to institutionalize the attitudes and objectives of the Ombudsman and PRP throughout the policies, procedures and personnel of all of the Service functions. Presently, the long-term goal of the Ombudsman and the PRP employees is to so institutionalize their attitudes and objectives across the Service that all of the Service employees will share such attitudes and objectives.

In our opinion, the proposal in H.R. 11 would do just the opposite. By creating a new office headed by an independent Presidential Appointee and given a function independent of the organization, the proposal separates PRP. In any large organization, once a program is separate, it is almost impossible to institutionalize the attitudes and objectives of the program. If the present proposal is enacted to statutorily mandate the Presidential appointment of a Taxpayer Advocate to whom the PRP program will be responsible, we believe that the detriments resulting from such change will more than offset any intended benefits.

We are particularly concerned that such change may politicize the Ombudsman and thereby render the Ombudsman less effective in leading and managing PRP. As you may know, the Ombudsman presently is involved personally on a daily basis in numerous audit, collection and other enforcement activities affecting specific taxpayers. Often, taxpayers or their representatives request the involvement of the Ombudsman. History has taught all of us, and particularly those who are signatories, of the dangers inherent in the involvement of political appointees in such activities on a day-to-day basis at the request of taxpayers. We oppose and urge you to reject this proposal.

3. Retroactivity of Treasury Regulations. Presently, Treasury and IRS officials have discretion about the extent to which regulations can be promulgated retroactively. Under Section 5803 of H.R. 11, proposed and temporary regulations could not be applied retroactively to periods preceding the date of publication unless Congress so provided or unless necessary to "prevent abuse of the statute to which the regulation relates" or "correct a procedural defect in the issuance of any prior regulation".

All of us as former Commissioners, and certainly as practitioners, support the notion that regulations should be issued promptly after legislation is enacted in order to provide affected parties with appropriate guidance and also to avoid the problems which retroactivity creates. However, because of the volume and complexity of tax legislation so frequently passed by Congress over the last thirty years, in our experience it has been increasingly difficult (maybe impossible) for the Treasury Department and the Service to issue regulations as promptly as desirable and needed. Further, it is our collective experience that, under our government of checks and balances, it is often easier for taxpayers and their representatives to block or defer the issuance of regulations than it is for the Service to issue them timely, particularly those regulations that are perceived to affect the interests of taxpayers adversely.

Each of us has had to deal with the delicate and difficult decision as to whether and to what extent a regulation should be retroactive or prospective. Each of us has had to deal with a variety of different situations in which retroactivity, rather than prospectivity, was called for or required. We do not believe that the exceptions in the proposal to permit retroactivity are sufficient to cover the myriad of situations and conditions in which the issue arises. Indeed, in light of these circumstances, we seriously doubt the wisdom of attempting to prescribe in advance when regulations should be promulgated retroactively or prospectively. We believe that flexibility to respond to the exigencies of the particular situation is critically important, and that that is fundamentally what is involved in the present provisions of Section 7805(b) of the Code.

In balancing the needs of the Service with the rights of the taxpayers, we believe that the present flexibility should be continued. Courts have fashioned numerous remedies to permit taxpayers to overturn or circumvent regulations in appropriate circumstances. Over the last thirty years the courts consistently have demonstrated a willingness to uphold taxpayers' actions despite contrary provisions of the regulations when the court determines that the taxpayer has substantially complied with his or her tax obligations or that the Service has abused its discretion in formulating or administering its regulations. See, e.g., Fred J. Sperapani, 42 T.C. 308, 333 (1964); Columbia Iron & Metal Company, 61 T.C. 5, 10 (1973); Jaquelin E. Taylor, 67 T.C. 1071, 1079 (1977); Chester Matheson, 74 T.C. 836, 841 (1980); Young v. Commissioner, 783 F.2d 1201, 1205 (5th Cir. 1986); Woodbury v. Commissioner, 900 F.2d 1457, 1460 (10th Cir. 1990); White Rubber Corporation v. United States, 781 F. Supp. 507, 511 (N.D. Ohio 1991).

For the reasons noted, we oppose the proposal and encourage you to reject it.

If you or your staffs would like to confer with us as a group or individually, we would be pleased to assist you.

Mortimer M. Caplin, Former Commissioner 1961-1964

Sheldon S. Cohen, Former Commissioner 1965-1969

Randolph W. Thrower, Former Commissioner 1969-1971

Johnnie M. Walters, Former Commissioner 1971-1973

Donald C. Alexander, Former Commissioner 1973-1977

Jerome Kurtz, Former Commissioner 1977-1980

Roscoe L. Egger, Jr., Former Commissioner 1981-1986

Lawrence B. Gibbs, Former Commissioner 1986-1989

cc: The Honorable Bob Packwood
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Ranking Minority Member
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April 12, 1995

The Honorable Nancy L. Johnson
Chairwoman, Subcommittee on Oversight
Committee on Ways and Means
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Madam Chairwoman:

Thank you for your invitation to appear as a witness at the Oversight Subcommittee's hearing on March 24, 1995, on "Taxpayer Bill of Rights 2" (TBR2). While I was unable to attend, I am pleased to provide you with my statement and observations for inclusion in the Subcommittee's printed hearing record. First, I want to commend you for holding a hearing on TBR2 as one of the first hearings conducted under your stewardship. By placing this issue at the top of your list, I believe you have sent a strong signal to the Internal Revenue Service (IRS) and the American taxpayer that the need for TBR2 has not diminished.

When I assumed the Chairmanship of the Subcommittee on Oversight in 1985, the IRS was not required to provide every taxpayer it questioned or examined with a comprehensive statement explaining taxpayer rights nor was the agency prohibited from evaluating its collection agents based upon their collection results. Taxpayers did not have a statutory right to pursue installment agreements with the IRS nor did they have a legal right to seek the abatement of interest in cases where the IRS had erred or caused delay. Taxpayers were powerless to seek redress for reckless IRS collection activities and were denied reimbursement for attorney fees even when they prevailed over the IRS. These and other rights, which were established in 1988 as part of the original Taxpayer Bill of Rights (TBR), make so much sense that today we tend to take them for granted.

When we enacted the original TBR legislation in 1988, we took a significant step forward in protecting the rights of individual taxpayers. We knew then that this was not a cure all for all taxpayer problems and our efforts to protect the legitimate interests of taxpayers were by no means over. Subsequent to the enactment of TBR, additional problems surfaced and the need for additional legislation became apparent. As you know, many of the provisions contained in pending legislation (H.R. 661 and S. 258, introduced by Representative Thornton and Senator Pryor, respectively), were actually developed by the Oversight Subcommittee over the past few years. In fact, much of the current legislation was actually passed by Congress on two separate occasions in 1992, only to be vetoed by the President for reasons unrelated to TBR2.

The IRS touches the lives of more people than any other government agency and, therefore, it is extremely important that Congress remain vigilant in ensuring that the enormous powers of the IRS are used properly and fairly. Some would say that Congress should not attempt to micro manage the IRS or seek legislative remedies to the administrative problems taxpayers encounter in their dealings with the IRS. In my judgment, the original TBR was probably the most important new tax law in recent history and helped restore confidence in our voluntary tax system by providing real and substantive relief for the average taxpayer. Looking back, I sincerely doubt whether IRS on its own would have taken the actions necessary to effectively address the serious problems identified by Congress. In my judgment, it is not only entirely appropriate, but essential for Congress to regularly oversee the operations and practices of the IRS and to establish safeguards, statutorily if necessary, where it is deemed appropriate.

Taxpayers deserve to be treated fairly, professionally, promptly, and courteously by the IRS. I think that IRS employees try to be understanding and helpful most of the time. But occasionally, they can seem awfully heavy-handed and hard-hearted. Although the job of collecting the nation's taxes is difficult, there is absolutely no reason to mistreat or abuse an individual taxpayer. This is especially true in the case of a taxpayer who is trying to comply with our complicated set of tax laws and who, for one reason or another, gets needlessly caught up in a never ending dispute with the IRS. It is to protect these honest, hard working, everyday American taxpayers that every effort should be made to enact TBR2.

As a general proposition, H.R. 661 and S. 258 are both very good bills and I enthusiastically support them. The bills, as well as the legislation I developed in the 103rd Congress, contain well-reasoned and responsible pro-taxpayer provisions which should be included in any Oversight Subcommittee package or legislation you develop this year. These bills will:

- Improve installment agreements by requiring prior notice of their cancellation, allowing for administrative appeals, and suspending certain penalties while they are in effect.

- Expand the authority of the IRS to abate interest payments and give taxpayers additional time after receiving a notice and demand to pay the tax without further interest.

- Provide protection to spouses filing joint returns and require IRS to take all reasonable steps to notify both spouses of any deficiencies on the return.

- Improve the procedures concerning liens, levies and offers-in-compromise.

- Require IRS to verify the accuracy of information returns, the inclusion of the payor's telephone number on such returns, and give the taxpayer a civil cause of action if an information return is fraudulently filed.

- Provide additional notice and protection for taxpayers who are determined to be "responsible officers" in Federal tax deposit situations.

I recognize there is more than one way to build a mouse trap and that some modifications to these provisions may be necessary and desirable. I also believe there are probably a few additional measures that ought to be included TBR2 and would encourage their consideration. As an example, I would encourage you to give serious consideration to including a provision requiring comprehensive crediting procedures for the netting of overpayments and underpayments for the calculation of interest. On three separate occasions, Congress instructed the IRS to implement comprehensive netting rules so that taxpayers would not be unfairly subjected to excessive interest charges during periods when there was a mutuality of indebtedness between the taxpayer and the Government. The IRS' continued failure to issue procedures, coupled with the inconsistent manner in which IRS is currently administering the interest provisions, has resulted in disparate treatment among similarly situated taxpayers. I would caution, however, against listening to the naysayers who argue that a particular provision in TBR2 is unnecessary, unworkable, or unadministrable. In my experience, I seldom found this to be true. It always seemed to be more of a reflection of an agency's desire to conduct business as usual.

Let me provide you with some of the circumstances which gave rise to the provisions under consideration today and why I think we need TBR2. Imagine if you will, a twenty-one old secretary-bookkeeper, working at her first job for a small business. Her duties

include making routine reports to the company president on the company's bank balances. In addition, she is authorized to sign checks, as a convenience to the president, who is frequently out of town on business. She never signs any checks without previous permission, and has no involvement with the company's financial and tax decisions. She is not a CPA, and is not trained or expected to know all the facts about the company's tax obligations. This secretary certainly does not know that this company has not timely deposited its payroll taxes for the past six months. More importantly, she does not know, and has never been told that she can be held personally liable for those taxes. Even if her boss says she was not responsible, she can be held personally liable by the IRS. This is not right, and the provisions contained in TBR2 would correct this problem.

Imagine that a taxpayer receives a letter from the IRS questioning a deduction on his tax return, asking for further substantiation, and telling him that, based on the information he supplied, the IRS will make a final decision. He promptly responds by certified letter, and he hears nothing more from IRS. A couple of years pass, and, out of the blue, the IRS writes the taxpayer, disallowing his deduction, and assessing tax, penalties, and interest. In checking into the matter further, he learns that the two year delay was the result of the IRS "losing" his file, because the person working the case was transferred, and the case was not promptly reassigned. In fact, the IRS even admits its mistake, does not try to defend the situation, and perhaps even apologizes for the delay. No matter, the IRS cannot abate the interest due to its own mistakes. The taxpayer is expected to pay the cost of the IRS delays, which he did not cause, did not want, and could not have prevented. This is not right, and the interest abatement provision in TBR2 corrects this problem.

Imagine a small business owner who recently settled a dispute with the IRS concerning the appropriate tax treatment of contributions she made to her company's employee pension plan. As part of this settlement, she is now paying her tax in full, with interest, in installments over the next six months. Unfortunately, the IRS agent handling the case accidentally files a lien against the company's assets, and has this lien publicly recorded. The company's credit is now destroyed, her commercial loan agreements are now subject to immediate repayment, and her ability to remain in business is in grave jeopardy. The IRS admits it made a mistake, and that the lien never should have been recorded. Too bad, the IRS cannot withdraw the lien until she pays the company's tax liability in full. This is not right, and the lien provisions contained in TBR2 correct this problem.

Imagine a divorced taxpayer who filed separate tax returns for the past several years. However, the IRS has audited the joint returns she filed with her husband when they were married. The IRS never notified her of the examination and has sent a notice of deficiency to her former husband. The IRS has never even attempted to call or write her until she receives a letter telling her that her bank account has been levied and a lien placed on her house. She is further told that her time for administrative appeal has passed, and that she has no choice but to pay the tax, penalty, and interest in full, and then sue the IRS in Federal district court for a refund. This is not right, and the provisions contained in TBR2 correct this problem.

Imagine a taxpayer who receives a letter from the IRS asking why he did not report $30,000 in additional income he supposedly received when he filed his income tax return two years earlier. Unfortunately, he has never heard of the company that supposedly paid him the money, nor does he have any record of ever receiving any money. He has no way of contacting the company, and the "information return" the company filed does not even provide a telephone number of where they can be reached. So the taxpayer calls the IRS to explain the situation and is told that the IRS is entitled to the presumption that this third party return is correct, and that he is responsible for reconciling the discrepancy. Even worse, if he can not straighten the mess out then he must pay the tax, penalty and interest. And even if the taxpayer discovers that the whole dispute was the result of a malicious act

by someone intent on harassing him, he can not sue for damages because there is no Federal cause of action available under existing law. This is not right, and the information return provisions contained in TBR2 correct this problem.

I could go on all day about the problems that taxpayers experience all too frequently in their dealings with the IRS. TBR2 effectively addresses many of them and would provide the American taxpayer with long overdue relief. TPR2 is a responsible package of reform measure and enjoys wide-spread support throughout the tax community.

In closing, I would like to discuss one area that may be the subject of some discussion in the months ahead. Included in TBR2 is a provision which would establish a new position of Taxpayer Advocate within the IRS. The Taxpayer Advocate would have the responsibility to supervise and direct the activities of all problem resolution officers and would have broader authority to act on behalf of individual taxpayers. The Taxpayer Advocate would be required to submit reports to the Congressional tax writing committees identifying significant problems that taxpayers face in dealing with the IRS and the Advocate's recommendations for improvement. Many have commented on whether the Taxpayer Advocate should be nominated by the President and confirmed by the Senate, in essence a political appointee.

While Congress cannot appropriate common sense or pass legislation to fix every injustice that takes place at the hands of the IRS, Congress can certainly see to it that the interests of taxpayers are fully protected by someone who has the stature, independence and authority within IRS to take appropriate action and seek improvements when necessary. I believe the only way to accomplish this is to have an independent Taxpayer Advocate who is required to report regularly to Congress, so that those who are truly held accountable for the actions of the IRS, might know exactly what is going on. The Taxpayer Advocate must be required to make reports directly to the Congress so that his or her voice on behalf of the everyday working American taxpayer will never be swallowed up in the halls of the IRS and Treasury bureaucracies, as is the case today. I believe the provision establishing a truly independent Taxpayer Advocate is the crown jewel of TBR2 and, in my judgment, it would be a terrible mistake to eliminate an independent selection process which ensures accountability to the American taxpayer. Claims that adding an additional political appointee would increase the potential for political abuse are simply unfounded and absurd.

I appreciate the opportunity to offer my thoughts and I wish you the best of luck in the months ahead as you champion the cause of TBR2. Please feel free to call upon me if I can be of any assistance.

With best regards, I am

Sincerely yours,

J. J. Pickle

cc: The Honorable Bob Matsui
The Honorable Sam Gibbons
The Honorable Bob Packwood
The Honorable David Pryor

HAROLD C. TINT
30 East 65th Street
New York, New York 10021

1 April 1995

Mr. Philip D. Moseley
Chief of Staff
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Moseley:

I write this letter in support of Congresswoman Nancy L. Johnson, Chairman of the Subcommittee on Oversight of the Committee on Ways and Means, in her efforts to strengthen the protection of taxpayers through the proposed Taxpayer Bill of Rights II.

My recent experiences by members of the Internal Revenue Serices's legal department right up to the Chief Counsel's office in Washington, D.C. clearly demonstrates the need for change regarding the protection of honest taxpayers in legitimate disputes with the Service. The acts of apparent violations of my rights as an American citizen were systematic and most frightening and were carried out by the District Counsel who handled my case, the Regional Counsel of the North Atlantic Region and by an Assistant Chief Counsel in his refusal to accept any of my charges.

What makes my case so unusual is the fact that after all court hearings had been concluded, the District Counsel John M. Elias, Esq. gave a sworn deposition testimony which supported all of the claims I had made regarding the violation of my rights. In that testimony the District Counsel not only admitted stating a known false statement of great significance to the Tax Court but also that he had withheld an essential document in his files and in direct violation of the Tax Court's order to provide my attorney with all documents in his possession in pre-trial discovery.

In his deposition testimony, the District Counsel also detailed certain outrageous acts by his superior Regional Counsel Agatha L. Vorsanger, Esq. of the North Atlantic Region of the Internal Revenue Service. As recently as February 3, 1995, Daniel J. Wiles, Esq., Assistant Chief Counsel of the Internal Revenue Service stated in a letter to United States Senator Daniel P. Moynihan that "my complaints are unfounded."

I wish to suggest most respectfully that a change to require the government to be the plaintiff in actions against a taxpayer is necessary to prevent the type of abuse I encountered. Because I was required to be the petitioner after receiving a notice of a disallowance issued by the government without any known basis, I faced a government attorney who conducted all the required pre-trial conferences without knowing the facts and merits of the transaction that had been disallowed. Such a fundamental violation could not have occurred had the government been forced into the role of the plaintiff as is customary in the American judicial system.

Before outlining the specifics of my case, I wish to call to your attention the professionalism and integrity of staff members of the Internal Revenue Service. The people I wish to cite are a credit to the high ideals one should encounter from government agents: Revenue Officers Stephen A. Sica and Delma Marchand; Appeals Officer John L. Dotoratos; Supervisor Gilbert Moran; and Collection Officer Elizabeth Kishlansky. All of the named are members of the Manhattan District Office. I also wish to note the integrity of Revenue Officer Robert Aramayo who stated to me early on in my case:

> "Mr. Tint, I know you are a businessman and may have something to hide. If you do, you better pay up as they are going after you. They are bullying you like they do to a lot of people. If you have nothing to hide, I wish you would stand up for your rights. You will be doing a service for many people."

Having "nothing to hide", I accepted the challenge.

In 1978 I invested in two computer leasing transactions that were tax deferrals, not shelters, and received a Notice of Deficiency disallowing both transactions in April, 1983. One was accompanied by an agent's report as required; on the other the Service simply disallowed it based on its appearance on the Schedule E portion of my income tax return. The Service knew so little about this transaction that the amount was overstated for 1979 alone by over $ 50,000. It is this second transaction and the manner in which it was handled that is the subject of this letter. To compound this situation is the fact that my partner had been examined on his identical participation in this transaction and had been cleared after examination.

The IRS sent a formal notice with the disallowance "Rights of a Taxpayer" which provides for settlement discussions within the Service. At two meetings under this provision, my attorney and I were advised that the Service had no information and could not hold such a conference as stated in its Publication 5. As a law-abiding citizen, I then instructed my attorney to provide any and all the information I had. The letters of request - which I have - came over a period of almost ten months. However I received a letter from the Service to

the effect that the time for IRS settlement had passed and that the case was being forwarded to the legal department. No conference had occurred as provided in the "Rights Publication."

Many months later, my attorney and I met with the District Counsel John M. Elias, Esq. who had been assigned to my case. This was to be the informal settlement conference as is customary in such matters; but the District Counsel did not know anything about this transaction. I did tell him that my partner had been examined and cleared. The District Counsel explained that what was in another taxpayer's name could not be used by me. What he did not reveal at the time was the essential fact that he had an IRS Engineering Report in my name in his file and that report could have been used to clear me in the same way as my partner had been cleared.

The failure to disclose this information by deliberate withholding presents a clear violation of the law and my rights. It was only the beginning for me. But what makes this case so unusual is the fact that after all the unfavorable court decisions, the District Counsel somehow felt compelled to speak the truth about the systematic abuse of my rights by the IRS including himself and revealed all this in a sworn deposition. As will be shown, this act of integrity appears to have infuriated senior members of the Service's legal department.

After this futile conference I asked the help of my United States Senator Daniel P. Moynihan not to get a favorable decision but to have one conference where I could settle based on the facts and issues and not just receive a "take-it-or-leave-it" offer - i.e. pay up or go to court. The Senator's office then sent a letter based on my request to the IRS office here in New York.

In deposition testimony, the District Counsel testified that Regional Counsel Agatha L. Vorsanger, Esq. treated this letter from a United States Senator "in jest" and pretended "to give me a ribbing because of the accusations that were raised in the letter." There were two other letters written by the Senator's office over his signature with all answered by Regional Counsel Agatha L. Vorsanger, Esq. In the three lettrs of Regional Counsel Vorsanger, Esq., she appears to have directly lied six times to the Senator in stating "the merits of Mr. Tint's case had been discussed." The basis for my accusation also lies in the District Counsel's sworn deposition testimony that he was not prepared to discuss the facts at any meeting.

The most important protection for taxpayers against any arbitrary abuse of power lies in Tax Court Rule 70 (a)(1) which mandates that "both sides must conduct a pre-trial conference with an exchange of necessary facts, documents and other data between the parties as an aid to the more expeditious trial of cases as well as for settlement purposes." In deposition testimony, the District Counsel stated "He was not prepared to proceed further" at our

Rule 70(a)(1) Conference held on February 12, 1986.

About that time I was able to hold a conference with Jerome Kurtz, Esq. - former IRS Commissioner - who told me that I should report to the Tax Court that I had not had a proper Rule 70 (a)(1) Conference. I followed his good advice and told this to the Tax Court at trial. The District Counsel in reply gave the Court an entirely fictitious account of what had actually transpired at that Conference. The Tax Court accepted his false version.

I have been subsequently advised by counsel that a false statement, knowingly made, designed to mislead the Court constitutes perjury. I would never want to bring such an action against the District Counsel in response to his open and honest confession as I believe his integrity - although belated - is of the highest order. But it is seemingly impossible for me to understand how the Chief Counsel's office can dismiss my charges "as unfounded" as Assistant Chief Counsel Daniel J. Wiles, Esq. has noted in the enclosed letter of February 3, 1995 to Senator Daniel P. Moynihan.

On February 26, 1986, the District Counsel finally made and sent an analysis of the transaction. Upon receipt, my attorney called the Regional Counsel and asked for one settlement meeting based on that letter. Regional Counsel Agatha L. Vorsanger, Esq. * denied his request and then directly threatened him because I, his client, had written to Senator Moynihan. This was testified to in Court and was unchallenged by the government attorney and so stands. My attorney was a staff member of a New York accounting firm whose partners were fearful of the wrath of the Regional Counsel. The attorney resigned. This was six weeks before the scheduled court trial. The Tax Court ruled that the substitute attorney chosen in great haste was unprepared and I lost my case "For Failure To Prosecute."

The Regional Counsel in another matter abused me personally. The Chief Counsel's office had become interested in my case with its failure by the Service to afford a bonafide settlement conference. After much encouragement, the representative wrote a letter cancelling any further contact. In sworn deposition testimony the District Counsel testified that Regional Counsel Agatha L. Vorsanger, Esq. sent notice to the Chief Counsel's office that I had threatened the District Counsel at a conference. Such a threat constitutes a felony. I knew nothing about this at the time as there was no threat and if something as serious as that had indeed occurred, I believe the Regional Counsel had an obligation under the law to so advise me and not send such information to the Chief Counsel's office behind my back. This was all disclosed by the District Counsel in his sworn deposition testimony.

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* Regional Counsel Vorsanger stated "Counsellor, I am considering disciplinary proceedings against you for your client writing to Senator Moynihan."

The withholding of crucial evidence in pre-trial discovery ordered directly by the Court and throughout the entire case is the final and, perhaps, the most serious charge. Rather than try to condense it in this letter, I have supplied two booklets which cover this serious matter in detail and with proof. The District Counsel who had handled my case was no longer with the Service when this matter was discovered. I filed a fraud charge and represented myself before the Second Circuit Court of Appeals. An attorney for the Department of Justice said there was no fraud as the Engineering Report while in my name was in files not in the possession of the District Counsel and that he had no knowledge of this report. This information appears to have come from a staff attorney of Regional Counsel Agatha L. Vorsanger, Esq.

My appeal was dismissed. A year later in deposition testimony, the original District Counsel testified that he had "the other file", did not know about this court action, and that he had not been asked about it by Regional Counsel Agatha L. Vorsanger's staff counsel Michael J. Wilder, Esq.

There is ample proof to support all of the stated charges. Upon request, such proof can be supplied. In addition to the lengthy sworn deposition testimony of District Counsel John M. Elias, Esq., I have documents obtained under the Freedom of Information Act and correspondence with the Service directly.

As a result of Taxpayers Bill of Rights I, the Internal Revenue Service published PUBLICATION 1 - YOUR RIGHTS AS A TAXPAYER which sets forth the issue of the Service protecting "the rights" of taxpayers. But as long as top officials of the IRS legal structure - the Regional Counsel of the North Atlantic Region and an Assistant Chief Counsel - feel no constraints then it appears that Congress can do what it wants for the Rights of Taxpayers' without it affording real protection. However, I feel strongly that a change in legal procedure by making the government the plaintiff would go a long way toward reducing or even eliminating such type of absue. Had such a procedure been in effect, the District Counsel could not have conducted himself as exhibited in my case.

I further believe that if the government after issuing a Notice of Deficiency retains the burden of proof, then the excesses I have reported regarding the conduct of Regional Counsel Vorsanger probably would not have occurred.

Upon request, I am prepared to offer any additional information as requested.

[Attachments retained in Committee Files]

Very truly yours,

Harold C. Tint
(212) 570 1765

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

FEB - 3 1995

Honorable Daniel P. Moynihan
405 Lexington Avenue
41st Floor, Suite 4101
New York, NY 10174-4101

Attention: Deborah A. Famighette

Dear Senator Moynihan:

This is in response to your letter of December 20, 1994, regarding an inquiry from Mr. Harold C. Tint. As you are aware, your inquiry has been forwarded to this office by Eugene D. Alexander, District Director, Internal Revenue Service-Manhattan Office. Mr. Tint raises several concerns about the handling of his case in the United States Tax Court. At issue in that case were Mr. Tint's investments in two tax shelters. Mr. Tint has written to you and the Internal Revenue Service on several other occasions about this same matter.

Mr. Tint's inquiries to the Commissioner of the Internal Revenue and to you were fully considered by this office on these prior occasions, and it was determined that Mr. Tint's case was properly processed by the Service. The United States Tax Court and the Court of Appeals for the Second Circuit, on two occasions, considered Mr. Tint's case and his arguments about the Service's conduct; and on both occasions, the Court of Appeals upheld the Tax Court's dismissal of Mr. Tint's petition. As recently as September 12, 1994, this office again reviewed this matter at Mr. Tint's request and advised him that the Office of Chief Counsel had considered his inquiry and had determined that his claims were without merit.

While it is unfortunate that Mr. Tint believes his case was unfairly handled, the thorough review of his case by the Internal Revenue Service and the federal court system indicates that his complaints are unfounded. There are no further administrative remedies available to Mr. Tint through the Internal Revenue Service. We hope this information is responsive to your concerns.

Sincerely,

DANIEL J. WILES
Assistant Chief Counsel
(Field Service)

HAROLD CHARLES TINT

HOME ADDRESS: 30 E. 65th St., New York, N.Y. 10021 (212-570-1765).
OCCUPATION: President, Charal Investment Company Inc.
OFFICE ADDRESS: P.O. Box 1485, Brick, N.J., 08723 (212-570-1765).
DEGREE: A.B., 1944(45).
MARRIED: Eleanor Klugman, 1951 (divorced, 1964).
CHILDREN: Charles H. Tint, 1954 (Hamilton Coll. '76), *m.* Liz Schlesinger; Alexandra K., 1957 (Goucher Coll.'80).
GRANDCHILDREN: Two.
OFFICES HELD: President, Charal Investment Co., Inc. and Value Oil Company; director, Merit Oil Co.; director, 30 East 65th Street Corp.; director, Toreador Royalty Corp., Dallas, Texas.

In 1960 I opened a retail gasoline service station in Union, New Jersey. By 1982, I was fortunate enough to have built a chain of eighteen retail gasoline stations in northern New Jersey. In early 1983, I sold this operation to the Merit chain of retail gasoline stations and have been retired from active business since that time. Since 1983, I have been somewhat active as a director of three companies, as noted, and have become an investor in common stocks based on the proceeds of that sale.

I also spent some twenty-five years during that time as an active football recruiter for the Harvard Athletic Department. This experience was personally as rewarding as was my business career financially rewarding.

I also served three years—1943-1946—in the Army Air Force as a weather observer and code clerk.

From 1986 to 1990, I battled the Internal Revenue Service on the issue of the Service failing to grant its stated rights to an individual. I argued my case on a *pro se* basis before the prestigious U.S. Court of Appeals for the Second Circuit. I was not successful but did enjoy the vindication of my position as stated by an IRS attorney in a deposition taken in a related legal matter. The power of an entrenched bureaucracy is a most powerful force and, based on my expertise in this case, I have become a strong advocate against the death penalty. At one point, unknown to me at the time, I was falsely accused of having threatened a government attorney at a conference. This was no idle matter as a memorandum to this effect was circulated at the Chief Counsel's office in Washington, D.C.

LIST OF ENCLOSED EXHIBITS:

1. Three letters of Regional Counsel Vorsanger to United States Senator Daniel P. Moynihan stating six times that the "merits" and/or facts had been discussed at conferences when in fact the District Counsel testified he did not know the merits at his personal conferences and "there was no discussion".

2. Evidence that District Counsel withheld crucial IRS Engineering Report despite Court Ordered exchange of documents in pre-trial Tax Court discovery.

3. Evidence regarding the withholding of the crucial IRS Engineering Report; the "spy story" of its discovery; mis-leading information being given to the Dep't of Justice.

TESTIMONY OF THE HONORABLE JAMES A. TRAFICANT JR. OF THE 17TH DISTRICT OF OHIO BEFORE THE OVERSIGHT SUBCOMMITTEE OF THE HOUSE WAYS AND MEANS COMMITTEE

First of all, Madam Chairwoman, I would like to take this opportunity to thank you for permitting me to testify before the Committee. We, as Members of the 104th Congress, have the responsibility of re-establishing the trust the American people have lost in the Federal government. That relationship starts with the Internal Revenue Service. If Americans believe that the Internal Revenue Service and the tax code served them, and not the reverse, confidence in the federal government would most certainly rise.

I want to applaud the subcommittee for tackling the issue of taxpayers rights. It is an issue I have championed since coming to Congress in 1985. I like to talk about the taxpayer rights issue that is central to this whole debate.

Last year I introduced legislation to protect taxpayers from capricious behavior by the Internal Revenue Service. I have once again introduced the bill, H.R. 390 which would shift the burden of proof in all civil tax cases from the taxpayer to the IRS. Too often, the IRS is an agency out of control; too many Americans fear the IRS and that's wrong. So far this year, over 260 members of Congress have co-sponsored this bill.

Madam Chairwoman, my bill has three sections to protect Americans from IRS abuses. First, damages paid to the taxpayer are increased from $100,000 (current law) to $1,000,000. Second, the bill requires the Internal Revenue Service to notify the taxpayer promptly, in writing and upon request as to the specific implementing regulations the IRS claims they have violated. No more ambiguous computer generated letters using code numbers. No more unprepared confrontations with the IRS. These two seemingly innocuous sections of my bill are extremely vital, and will go a long way in rebuilding the American people's faith in our government.

The last part of my bill is the most important: it shifts the burden of proof from the taxpayer to the IRS in civil tax cases. Under current law, if the IRS accuses someone of tax fraud (which could be an honest mistake on the 1040 form), he or she must prove his or her innocence in civil court, the IRS does not have to prove your guilt. An accused mass murderer has more rights than a taxpayer fingered by the IRS. Jeffrey Dahmer was considered innocent until proven guilty. Mom and Pop small business owners, however, are not afforded this protection.

During the last session, I highlighted the need for this legislation on the House floor by reading letters and case histories sent be me by people across the country. You may remember the case of David and Millie Evans from Longmont, Colorado. The IRS refused to accept their cancelled check as evidence of payment even though the check bore the IRS stamp of endorsement. Or how about Alex Council, who took his own life so his wife could collect his life insurance to pay off their IRS bill? Months later, a judge found him innocent of any wrongdoing. I have heard hundreds of stories of IRS abuses like these on radio and television talk shows. Thousands of Americans have written to me personally with their horror stories.

Opponents argue that my bill will weaken IRS's ability to prosecute legitimate tax cheats. This bill will not effect IRS's ability to enforce tax law, it only forces them to prove allegations of fraud. My bill will ensure that IRS agents act in accordance with the Standards of Conduct required of all Department of Treasury employees and the Constitution of the United States of America. Innocent until proven guilty... that's what my bill is about.

Madam Chairwoman, I urge you to approve my bill. It should be your number one legislative goal for the 104th Congress. All I seek is fairness for the American people.

As I have stated earlier, I have championed this legislation for several years. The bill has enjoyed the strong support of both Republicans and Democrats. In fact, last year more than 120 Members signed a discharge petition to force the bill from the Ways and Means Committee to the House floor for a vote. Madam Chairwoman, a basic tenet of the American justice system is "innocent until proven guilty." H.R. 390 simply ensures that this sacred principle is extended to every corner of our justice system. All too many lives have been ruined unjustly and without cause by an IRS that is all too often out of control. Most average Americans don't have the financial resources to engage in a prolonged battle with the IRS. Most Americans, when accused by the IRS, simply pay the fine -- even though they know they did nothing wrong. Many of those who choose to fight either go broke or lose everything. My bill provides some modest safeguards to ensure that the IRS only brings a case when it has clear evidence that a taxpayer has engaged in fraudulent or illegal activity.

Any tax reform measure approved by the 104th Congress should include this provision.

Madam Chairwoman, again, I want to thank you for affording me this opportunity to testify before your august body. I hope to work with you on this and other tax measures in the weeks and months ahead.

ADMINISTRATION'S PROPOSAL RELATING TO THE TAX TREATMENT OF AMERICANS WHO RENOUNCE CITIZENSHIP

HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

OF THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDRED FOURTH CONGRESS

FIRST SESSION

MARCH 27, 1995

Serial 104–42

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ADMINISTRATION'S PROPOSAL RELATING TO THE TAX TREATMENT OF AMERICANS WHO RENOUNCE CITIZENSHIP

MONDAY, MARCH 27, 1995

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT,
Washington, DC.

The Subcommittee met, pursuant to call, at 12:10 p.m., in room 1100, Longworth House Office Building, Hon. Nancy L. Johnson (Chairman of the Subcommittee) presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON OVERSIGHT

FOR IMMEDIATE RELEASE
March 17, 1995
No. OV-5

CONTACT: (202) 225-7601

JOHNSON ANNOUNCES HEARING TO EXAMINE THE ADMINISTRATION'S PROPOSAL RELATING TO THE TAX TREATMENT OF AMERICANS WHO RENOUNCE CITIZENSHIP

Congresswoman Nancy L. Johnson (R-CT), Chairman of the Subcommittee on Oversight of the Committee on Ways and Means, today announced that the Subcommittee will conduct a hearing to evaluate the provision in the Administration's FY 1996 budget proposals to impose a tax on U.S. citizens who renounce their citizenship and long-term resident aliens who give up their status as residents. **The hearing will be held on Monday, March 27, 1995, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 12:00 noon.**

This hearing will feature invited witnesses only. In view of the limited time available to hear witnesses, the Subcommittee will not be able to accommodate requests to testify other than from those who are invited. Those persons and organizations not scheduled for an oral appearance are welcome to submit written statements for the record of the hearing.

BACKGROUND:

U.S. citizens (regardless of their residence) and resident aliens generally are subject to U.S. income taxation on their worldwide income. The U.S. tax may be reduced or offset by a credit allowed for foreign income taxes paid with respect to foreign source income. Nonresident aliens are taxed at a flat rate of 30 percent (or a lower treaty rate) on certain types of passive income derived from U.S. sources, and at regular graduated rates on net profits derived from a U.S. business. Under present law, a U.S. citizen who abandons his or her citizenship with a principal purpose to avoid federal income tax may be subjected to an alternative taxing method on his or her U.S. source income for 10 years after expatriation.

Under the Administration's proposal, a U.S. citizen who relinquishes citizenship generally would be treated as having sold all of his or her assets at fair market value immediately prior to the relinquishment, and net gain from the deemed sale would be subject to U.S. income tax. The tax would also apply to a "long-term resident" (generally, a green card holder who resides in the U.S. for at least 10 of the prior 15 taxable years) who ceases to be subject to tax as a resident of the United States. The tax would apply whether or not the principal purpose of relinquishment of U.S. citizenship was tax motivated. The proposal would apply to U.S. residents who relinquish their citizenship and long-term residents who cease to be taxed as U.S. residents on or after February 6, 1995 (the date the Administration announced the proposal). On March 15, 1995, the Senate Committee on Finance adopted a modified version of the Administration's proposal during its consideration of H.R. 831.

H.R. 831, a bill to permanently extend the deduction for the health insurance costs of the self-employed, and for other purposes, was considered before the Committee on Ways and Means on February 8 and was passed by the House on February 2, 1995.

SCOPE OF THE HEARING:

Under present law, taxes are imposed on former U.S. citizens on U.S. source income for ten years following renunciation of citizenship if one of the principal purposes of the renunciation was to avoid U.S. income tax. A similar rule applies to resident aliens who cease to be residents. According to the Department of the Treasury, the existing rules to prevent tax avoidance through expatriation "have proven largely ineffective because departing taxpayers have found ways to restructure their activities to avoid those rules, and compliance is difficult to monitor." However, as the Administration's proposal is drafted, it would apply to *any* U.S. citizen who abandons his or her citizenship, not simply to those who expatriate for tax-motivated reasons.

The Subcommittee will examine the Administration's proposal and specific problems which the Internal Revenue Service has encountered in recent years in enforcing existing laws aimed at taxing former U.S. citizens who abandon their citizenship for tax-motivated reasons. If the aim of the Administration's expatriation proposal is to tighten the rules for tax-motivated expatriations, the Subcommittee wants to learn why the proposed solution applies broadly to all citizens who give up their U.S. citizenship, and consider whether more narrowly-targeted reforms would achieve the Administration's goals.

DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:

Any person or organization wishing to submit a written statement for the printed record of the hearing should submit at least six (6) copies of their statement by the close of business, Monday, April 3, 1995, to Phillip D. Moseley, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements wish to have their statements distributed to the press and interested public at the hearing, they may deliver 200 additional copies for this purpose to the Subcommittee on Oversight office, room 1136 Longworth House Office Building, at least one hour before the hearing begins.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal size paper and may not exceed a total of 10 pages including attachments.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. A witness appearing at a public hearing, or submitting a statement for the record of a public hearing, or submitting written comments in response to a published request for comments by the Committee, must include on his statement or submission a list of all clients, persons, or organizations on whose behalf the witness appears.

4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and the public during the course of a public hearing may be submitted in other forms.

*****

Chairman JOHNSON. Good midday, everyone, and thank you for taking part in this hearing with us this afternoon. Today, we will examine the administration's proposal to impose a new tax on people who give up their U.S. citizenship.

Before we begin, I want to observe that while this is a serious proposal dealing with an important matter, much of the rhetoric surrounding this proposal has been less than helpful in focusing on the merits of the issue. People who give up their citizenship are not necessarily economic Benedict Arnolds, as proponents would label them, just as millions of immigrants who created and enriched this Nation over 200 years ago were not traitors to the countries they left.

Opportunity was and is the goal of those who come to the United States and to its citizens. Nor is the proposal necessarily an economic Berlin Wall, as critics have labeled it. The exemption to the proposal is generous enough to impose tax only on those with significant assets. Of course, new tax proposals may often seem benign when enacted and become more onerous with the passage of time and the changing whims of the Congress.

Take, for example, the income tax which started at 1 percent in 1913 and look at the current $600,000 estate tax exemption on which this proposal is modeled and which has been proposed for amendment by current House Minority Leader Gephardt to be reduced to a $200,000 exemption. I am also concerned that this proposal has a broader reach than may be necessary to address the primary concerns raised by the administration.

As I understand the administration's argument, the concern is over U.S. citizens who renounce citizenship for tax avoidance, but who continue to spend significant amounts of time in the United States. This proposal targets all individuals who renounce citizenship, whether or not they have a tax avoidance purpose and whether or not they continue to return to the United States afterward.

I also take very seriously the human rights issues that some of our witnesses today will discuss. While this proposal may not violate any current laws, I think the United States should lead by example. Our national interests may not be best served by drawing what some would see as a narrow distinction between this proposal and similar exit taxes that we have criticized when they were imposed by other countries.

It is possible that this proposal could be rewritten in a way that would more directly address the concerns raised by the administration, but I am concerned that Congress will not have the time to do this in connection with the bill to extend the self-employed health insurance deduction, which we all acknowledge must be enacted very soon.

On Friday, the Subcommittee held a hearing on the taxpayer bill of rights. With the testimony from that hearing fresh in my mind, I want to emphasize how important it is that this proposal not become another source of potential procedural friction between the Internal Revenue Service and law-abiding taxpayers.

For example, I would view it as a significant abuse of taxpayers' rights if the IRS were to attempt to use this proposal, if enacted, to change in any way the treatment of U.S. citizens who have not renounced their citizenship, notwithstanding any suspicion that an

overzealous tax collector may have about a citizen's intentions. That is the gray area and the deep water of this proposal before us.

I would like to express my appreciation to the witnesses who have come here on less than short notice, and I look forward to their testimony. I also appreciate the commitment of my Chairman, Chairman Archer, to not support any tax changes that haven't undergone public hearing in the House, and for that reason, we have convened this hearing, even on rather short notice.

I thank you. I would like to welcome our first witness today, Joseph Guttentag, the International Tax Counsel for the U.S. Department of Treasury—excuse me one moment. Before we proceed, my colleague, Mr. Ramstad, a new and esteemed Member of this Committee and one who has had some important experiences that will be useful to us as we move forward in our work, would like to make an opening comment.

Mr. RAMSTAD. Thank you, Madam Chair. Very briefly, I appreciate your leadership in calling today's hearing on the administration's proposal. I also share your concerns relative to the rhetoric around here and I was interested in the President's radio address over the weekend when he asked that both Republicans and Democrats in the House, in light of last week's debate on the welfare bill, tone down our rhetoric, and I share that concern.

I think we need to work in a bipartisan, pragmatic way on all of these policy issues, but I also think it is important that the administration get the message, too, and tone down its rhetoric, because it is one thing to throw out caveats to keep the dialog from simmering and to be more statesmanlike, but it is another thing when the administration is out there fueling the flames.

So I think it works both ways. I think both ends of Pennsylvania Avenue would be well-served, and certainly the country, more importantly, would be well-served, if we all toned down the rhetoric. This bill, I think, is a good place to start fresh on a beautiful Monday morning here in Washington.

It is particularly timely that we review this proposal. As the Chair mentioned, it was included in the Senate version of the bill we recently passed to restore and make permanent the 25-percent tax deduction for health care costs of self-employed taxpayers.

The inclusion of this particular provision made it possible to raise the deduction to 30 percent beginning with 1995, which is more than appropriate. Some of us would like to see it raised to 100 percent for self-employed individuals, to put them on a level playingfield with their counterparts in the marketplace.

I am particularly interested, Madam Chair, in the testimony of the Treasury Department officials. This provision, while seemingly well-intentioned, appears to create an administrative nightmare for the Internal Revenue Service. I know the IRS already struggles to enforce Code section 877, which allows assessment of U.S. tax with respect to certain types of income for a period of 10 years after relinquishing citizenship.

I am curious how effective the Treasury Department estimates the IRS would be in enforcing the proposal under consideration. I am also curious what Treasury estimates the net Federal revenue gain will be.

In addition, Madam Chair, I share your concerns relative to the issues discussed last week in the taxpayer bill of rights, and I certainly look forward to examining all of these issues with our distinguished witnesses today. Thank you, Madam Chair.

Chairman JOHNSON. Thank you. Mr. Guttentag, will you proceed, please, and welcome.

STATEMENT OF JOSEPH H. GUTTENTAG, INTERNATIONAL TAX COUNSEL, U.S. DEPARTMENT OF TREASURY

Mr. GUTTENTAG. Thank you, Madam Chair and Subcommittee Members. I appreciate the opportunity to testify in support of the administration proposals and section 5, H.R. 831, as approved by the Senate, and designed to prevent a relatively few, very wealthy Americans from avoiding U.S. tax on millions of dollars of gains by renouncing their U.S. citizenship.

I would like to submit my complete statement for the record and summarize the administration's position.

Chairman JOHNSON. That will be done.

Mr. GUTTENTAG. Next month, millions of Americans will settle up with their government and finalize their tax obligations. Recent reports in Forbes and other media have described how a small number of Americans avoid their U.S. tax obligations by giving up their U.S. citizenship.

We believe that when a citizen changes his status to that of an alien, who is exempt from most U.S. tax, it is appropriate and fair to tax him on those gains on which tax has not previously been paid. These expatriates should not obtain an unfair advantage over those U.S. citizens who continue to meet their tax obligations to our government.

Many other countries, such as Canada, Australia and Germany impose similar taxes. Each country crafts its proposal to deal with its own basic tax structure and other fiscal considerations.

Opponents of this proposal imply that this tax is designed to prevent free immigration or deny other important human rights. The proposal submitted by the administration and as approved by the Senate does not in any way restrict Americans from entering or leaving the country. As a matter of fact, as noted by the Chair, many expatriating former Americans choose to spend a significant amount of their time in the United States, often with family members who have not renounced their citizenship.

My views on the human rights issue are strongly buttressed by others much more learned in this field than I and are set forth in a memorandum prepared by the Legal Advisors Office of the Department of State and in a recent letter to Assistant Secretary Samuels from a distinguished international lawyer, Professor Detlev Vagts of Harvard Law School. I would like to submit them both for the record at this time, Madam Chair.

Chairman JOHNSON. We will include them in the record, Mr. Guttentag.

[The following was subsequently received:]

SECTION 201 OF THE TAX COMPLIANCE ACT OF 1995: CONSISTENCY WITH INTERNATIONAL HUMAN RIGHTS LAW

Memorandum of the Department of State
Submitted for the Record by the Department of the Treasury

Hearing Before the Subcommittee on Oversight
Committee on Ways and Means
U.S. House of Representatives

March 27, 1995

The Department of State believes that Section 201 of the proposed Tax Compliance Act of 1995 is consistent with international human rights law, on the basis of information provided by the Department of the Treasury that persons affected would have the means to pay the tax and that such taxes would not be more burdensome than those they would pay if they were to remain U.S. citizens. As described below, closing a loophole that allows extremely wealthy people to evade U.S. taxes through renunciation of their American citizenship does not violate any internationally recognized right to leave one's country. It is inaccurate on legal and policy grounds to suggest that the Administration's proposal is analogous to efforts by totalitarian regimes to erect financial and other barriers to prevent their citizens from leaving. The former Soviet Union, for example, sought to impose such barriers only on people who wanted to leave, and not on those who stayed. In contrast, Section 201 seeks to equalize the tax burden born by all U.S. citizens by ensuring that all pay taxes on gains above $600,000 that accrue during the period of their citizenship. Unlike the Soviet effort to discriminate against people who sought to leave, we understand from Treasury that Section 201 does not treat those who renounce their U.S. citizenship less favorably than those who remain U.S. citizens.

Section 201 would require payment of taxes by U.S. citizens and long-term residents on gains above $600,000 that accrue immediately prior to renunciation of their U.S. citizenship or long-term residency status. We understand that these tax requirements are no more burdensome than those that they would face if they remained U.S. citizens or residents at the time

they realized their gains or at death. While U.S. tax policy generally allows taxpayers to defer gains until they are realized or included in an estate, we further understand that Section 201 treats renunciation as a taxable event because such act effectively removes the underlying assets from U.S. taxing jurisdiction.

International law recognizes the right of all persons to leave any country, including their own, subject to certain limited restrictions. Article 12(2) of the International Covenant on Civil and Political Rights provides that: "Everyone shall be free to leave any country, including his own." Article 12(3) states that the right "shall not be subject to any restrictions except those which are provided by law, are necessary to protect national security, public order (ordre public), public health or morals or the rights and freedoms of others, and are consistent with the other rights recognized in the present Covenant."

Section 201 does not affect a person's right to leave the United States. Any tax obligations incurred under Section 201 would be triggered by the act of renunciation of U.S. citizenship, and not by the act of leaving the United States. In addition, since during peacetime U.S. citizens must be outside the United States to renounce their citizenship (see 8 U.S.C. §§1481(a)(5),1483(a)) the persons affected by Section 201 would have already left the United States. Renunciation does not preclude them from returning to the United States as aliens and subsequently leaving U.S. territory. Accordingly, Section 201 does not affect a person's right or ability to leave the United States.

Inherent in the right to leave a country is the ability to leave permanently, i.e., to emigrate to another country willing to accept the person. The proposed tax is as unconnected to emigration as it is to the right to leave the United States on a temporary basis. It is not the act of emigration that

triggers tax liability under Section 201, but the act of renunciation of citizenship. These two acts are not synonymous and should not be confused with one another. Because the United States allows its citizens to maintain dual nationality, U.S citizens may emigrate to another country and retain their U.S. citizenship. Hence, the act of emigration itself does not generate tax liability under Section 201. Indeed, we understand from the Department of the Treasury that some of the people potentially affected by Section 201 already maintain several residences abroad and hold foreign citizenship. Moreover, in stark contrast to most emigrants, particularly those fleeing totalitarian regimes, it is reported that some continue to spend up to 120 days each year in the United States after they have renounced their citizenship.

While emigration from the United States should not be confused with renunciation of U.S. citizenship, it should nonetheless be noted that it is well established that a State can impose economic controls in connection with departure so long as such controls do not result in a de facto denial of emigration. As Professor Hurst Hannum notes in commenting on the restrictions on the right to leave set forth in Article 12 of the Covenant:

> "Economic controls (currency restrictions, taxes, and deposits to guarantee repatriation) should not result in the de facto denial of an individual's right to leave . . . If such taxes are to be permissible, they must be applied in a non-discriminatory manner and must not serve merely as a pretext for denying the right to leave to all or a segment of the population (for example, by requiring that a very high 'education tax' be paid in hard currency in a country in which possession of hard currency is illegal)."1/

A wealthy individual who is free to travel and live anywhere in the world, irrespective of nationality, is in no way comparable to that of a persecuted individual seeking freedom who is not even allowed to leave his or her country for a day. In U.S. law, the Jackson-Vanik amendment to the Trade Act of 1974 (19 U.S.C. §2432) is aimed at this latter case and applies to physical departure, not change of nationality. Examples of States' practices that have been considered to interfere with the ability of communist country citizens to emigrate include imposing prohibitively high taxes specifically applied to the act of emigration with no relation to an individual's ability to pay, or disguised as "education taxes" to recoup the State's expenses in educating those seeking to depart permanently. Such practices also include punitive actions, intimidation or reprisals against those seeking to emigrate (e.g., firing the person from his or her job merely for applying for an exit visa). It is these offensive practices that the Jackson-Vanik amendment is designed to eliminate and thereby ensure that the citizens of these countries can exercise their right to leave. (See Tab A for further analysis of the Jackson-Vanik amendment.)

The only international human rights issue that is relevant to analysis of Section 201 is whether an internationally recognized right to change citizenship exists and, if so, whether Section 201 is consistent with it. The Universal Declaration of Human Rights, which is in many respects considered reflective of customary international law, provides in Article 15(2) that: "No one shall be arbitrarily deprived of his nationality nor denied the right to change his nationality" (emphasis added).2/ Although many provisions of the Universal Declaration have been incorporated into international law, for example in the International Covenant on Civil and Political Rights, Article 15(2) is not. Accordingly, the question arises whether this provision could be considered to be customary international law.

States' views on this question and practices do vary. Many countries have laws governing the renunciation of citizenship, but renunciation is not guaranteed because they have also established preconditions and restrictions, or otherwise subject the request to scrutiny.3/ Professor Ian Brownlie has commented on Article 15(2) in the context of expatriation that: "In the light of existing practice, however, the individual does not have this right, although the provision in the Universal Declaration may influence the interpretation of internal laws and treaty rules."4/ Others agree with this position. (See Restatement of the Foreign Relations Law of the United States, §211, Reporters' Note 4). Nonetheless, the United States believes that individuals do have a right to change their nationality. The U.S. Congress took the view in 1868 that the "right of expatriation is a natural and inherent right of all people" in order to rebut claims from European powers that "such American citizens, with their descendants, are subjects of foreign states, owing allegiance to the governments thereof . . . ." (Rev. Stat. §1999).

It is evident, however, that States do not recognize an unqualified right to change nationality. It is generally accepted, for example, that a State can require that a person seeking to change nationality fulfill obligations owed to the State, such as pay taxes due or perform required military service.5/ This is especially true where the requirement is by its nature proportional to the means to pay, and thus does not present a financial barrier, which we understand from Treasury is the case here.

The consistency between Section 201 and international human rights law is further demonstrated by the practice of countries that are strong supporters of international human rights and that have adopted similar tax policies. According to the Report prepared by the Staff of the Joint Committee on Taxation, Germany imposes an "extended tax liability" on German citizens who emigrate to a tax-haven country or do not assume

residence in any country and who maintain substantial economic ties to Germany. Australia imposes a tax when an Australian resident leaves the country; such person is treated as having sold all of his or her non-Australian assets at fair market value at the time of departure. To provide another example, Canada considers a taxpayer to have disposed of all capital gain property at its fair market value upon the occurrence of certain events, including relinquishment of residency.

Accordingly, to the extent that Section 201 imposes taxes on persons who have the ability to pay and that are no more burdensome than those they would pay if they remained U.S. citizens, it would not raise human rights concerns with respect to change of citizenship for two reasons. First, U.S. citizens would remain free to choose to change their citizenship. This proposal does not in any way preclude such choice, even indirectly. We understand from Treasury that any tax owed, by its nature, applies only to gains and thus should not exceed an individual's ability to pay. Second, international law would not proscribe reasonable consequences of relinquishment, such as liability for U.S. taxes that accrue during the period of citizenship. We understand from the Department of the Treasury that the imposition of taxes under Section 201 would be equitable, reasonable and consistent with overall U.S. tax policy because the provision applies only to gains that accrued during the period of citizenship in excess of $600,000; the tax rate is consistent with other tax rates; and affected persons would have the financial means to pay the tax, either immediately or on a deferred basis. Obviously, there is no international right to avoid paying taxes by changing one's citizenship.

In conclusion, it is the view of the Department of State that, based on the information described above, Section 201 does not violate international human rights law. Accordingly, the debate on the merits of Section 201 should focus solely on domestic tax policies and priorities.

FOOTNOTES

1. H. Hannum, The Right to Leave and Return in International Law and Practice 39-40 (1987).

2. Article XIX of the American Declaration on the Rights and Duties of Man provides that: "Every person has the right to the nationality to which he is entitled by law and to change it, if he so wishes, for the nationality of any other country that is willing to grant it to him." The American Declaration is not a legally binding document.

3. See Coumas v. Superior Court in and for San Joaquin County (People, Intervenor), 192 P.2d 449, 451 (Sup. Ct. Calif. 1948). When confronted with Greek refusal to consent to an expatriation, the Supreme Court of California stated: ". . . The so-called American doctrine of 'voluntary expatriation' as a matter of absolute right cannot postulate loss of original nationality on naturalization in this country as a principle of international law, for that would be tantamount to interference with the exclusive jurisdiction of a nation within its own domain."

4. I. Brownlie, Principles of International Law (4th ed.) 557 (1990). Professor Lillich comments that "the right protected in [Article 15] has received very little subsequent support from states and thus can be regarded as one of the weaker rights . . . ." "Civil Rights," in T. Meron, Human Rights in International Law at 153-54 (1988).

5. A State should not, for example, withhold discharge from nationality if, inter alia, acquisition of the new nationality has been sought by the person concerned in good faith and the discharge would not result in failure to perform specific obligations owed to the State. P. Weis, Nationality and Statelessness in International Law (2nd ed.) 133 (1979). In Coumas, supra note 3, the Supreme Court of California observed that Greece qualified the right of expatriation on fulfillment of military duties and procurement of consent of the Government.

Section 201 of the proposed Tax Compliance Act of 1995 does not conflict with the Jackson-Vanik amendment to the Trade Act of 1974 (19 U.S.C. §2432). That amendment restricts granting most-favored-nation treatment and certain trade related credits and guarantees to a limited number of nonmarket economies that unduly restrict the emigration of their nationals. Specifically, it applies to any nonmarket economy which:

> "(1) denies its citizens the right or opportunity to emigrate;
>
> (2) imposes more than a nominal tax on emigration or on the visas or other documents required for emigration, for any purpose or cause whatsoever; or
>
> (3) imposes more than a nominal tax, levy, fine, fee or other charge on any citizen as a consequence of the desire of such citizen to emigrate to the country of his choice . . . ."

This provision, according to the Senate Finance Committee, was "intended to encourage free emigration of all peoples from all communist countries (and not be restricted to any particular ethnic, racial, or religious group from any one country)." (1974 U.S.C.C.A.N. 7338.) These countries were expected to "provide reasonable assurances that freedom of emigration will be a realizable goal" if they were to enter into bilateral trade agreements with the United States. (Id.)

The amendment does not apply to emigration from the United States or to the renunciation of U.S. citizenship. It has been suggested, however, that Section 201 would somehow conflict with the "spirit" or the "principles" of the Jackson-Vanik amendment. The Department of State does not agree with such proposition.

Generally, in implementing this statute, the President makes determinations concerning a nonmarket economy's compliance with freedom of emigration principles contained in the amendment. Such determinations take into account the country's statutes and regulations, and how they are implemented day to day, as well as their net effect on the ability of that country's citizens to emigrate freely. The President may, by Executive Order, waive the prohibitions of the Jackson-Vanik amendment if he reports to Congress that a waiver will "substantially promote" the amendment's freedom of emigration objectives, and that he has received assurances from the country concerned that its emigration practices "will henceforth lead substantively to the achievement" of those objectives. (19 U.S.C. §2431(c).)

Several types of State practices have been considered by the United States to interfere with the ability of communist country citizens to emigrate, such as:

- prohibitively high taxes specifically applied to the act of emigration with no relation on an individual's ability to pay or disguised as "education taxes" seeking to recoup the state's expenses in educating those who are seeking to permanently depart;

- punitive actions, intimidation or reprisals by the State against those seeking to emigrate (e.g., firing a person from his or her job merely for applying for an exit visa);

- unreasonable impediments, such as requiring adult applicants for emigration visas to obtain permission from their parents or adult relatives;

- unreasonable prohibitions of emigration based on claims that the individual possesses knowledge about state secrets or national security; and

- unreasonable delays in processing applications for emigration permits or visas, interference with travel or communications necessary to complete applications, withholding of necessary documentation, or processing applications in a discriminatory manner such as to target identifiable individuals or groups for persecution (e.g., political dissidents, members of religious or racial groups, etc.).

Examples of these practices in the context of the former Soviet Union are described in an exchange of letters between Secretary of State Kissinger and Senator Jackson of October 18, 1974, discussing freedom of emigration from the Soviet Union and Senator Jackson's proposed amendment to the Trade Act, now known as the Jackson-Vanik amendment. (Reprinted in 1974 U.S.C.C.A.N. 7335-38.)

As explained in the accompanying memorandum, Section 201 does not deny anyone the right or ability to emigrate, and does not impose a tax on any decision to emigrate. Neither does the proposed tax raise questions of disparate standards applicable to the United States as against the nonmarket economies subject to Jackson-Vanik restrictions.

The emigration practices of those countries which have been the target of Jackson-Vanik restrictions have typically involved individuals or groups that have been persecuted by the State (e.g., dissidents), precluded family reunification, applied across the board to all citizens by a totalitarian State in order to preclude massive exodus, or have otherwise

been so restrictive as to effectively prevent the exercise of the international right to leave any country including one's own (as recognized in Article 12(2) of the International Covenant on Civil and Political Rights and further described in the accompanying memorandum). Furthermore, the primary objectives of those seeking to emigrate from those countries have been to avoid further persecution or to be reunified with their relatives, and to leave permanently. It was the act of leaving for any period of time that the State sought to block. None of these conditions are comparable to the exercise of taxing authority by the United States under Section 201 or to the status of the individuals who would be subject to that tax.

As stated in the accompanying memorandum, Section 201 would not interfere with the right of an individual to physically depart from the United States, whether temporarily or permanently.

HARVARD LAW SCHOOL
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March 24, 1995

Hon. Leslie B. Samuels
Assistant Secretary (Tax Policy)
Department of the Treasury Washington. D.C. 20220
Fax: 202-622-0605

Dear Secretary Samuels,

Your office has requested my views as to international law implications of the proposed tax on expatriates that would be imposed by section 5 of H.R. 831. You will understand that this is my personal opinion and in no way purports to represent the views of the institution to which I belong. It is also compact in form due to the constraints of time imposed by your legislative schedule and my own impending travel.

The right of expatriation has always been highly valued by the United States, which has defended it against the claims of other nations that refused to let their citizens go. The right to make this choice is the counterpart of the right not to lose one's citizenship except by one's own voluntary choice, a right underlined by opinions of the Supreme Court. However, in my view, the proposed tax does not amount to such a burden upon the right of expatriation as to constitute a violation of either international law or American constitutional law. It merely equalizes over the long run certain tax burdens as between those who remain subject to U.S. tax when they realize upon certain gains and those who abandon their citizen while the property remains unsold.

Furthermore, the proposed tax does not except, in the most indirect way, burden the right to emigrate. It is the right to emigrate rather than the right to expatriate onesself which is the subject of various conventions and of customary international law. As stated in the preceding paragraph, it basically equalizes certain tax burdens. It is not comparable to the measures imposed by such countries as the former Soviet Union and German Democratic Republic which were obviously and intentionally burdens on the right to emigrate.

In arriving at these conclusions I have reviewed various materials such as your statement before the Subcommittee on Taxation and Internal Revenue Oversight, two opinions of the Office of the Legal Adviser, U.S. State Department, the views of Professors Paul Stephan III and Robert Turner and others.

Very truly yours,

Detlev F. Vagts
Bemis Professor of Law

Mr. GUTTENTAG. Thank you. The argument has also been made that the provision is somehow unconstitutional on the grounds that no taxable gain has been realized by the former American. This argument is also without merit. There are similar taxing regimes already in the Internal Revenue Code whose constitutionality has been upheld against similar challenges.

For example, the foreign personal holding company rules applicable to corporate and individual stockholders and the controlled foreign corporation regime that also applies to corporate and individual shareholders have both been upheld by the courts against challenges that they were unconstitutional, that it was unconstitutional to tax unrealized income.

We must remember that we are not writing on a clean slate. The proposal under discussion is an amplification and improvement of section 877 of the Code which was enacted almost 30 years ago. Unfortunately, section 877 has proven ineffective in addressing the abuses at which it was targeted. The old section 877 taxed expatriate Americans for 10 years but only on certain gains and in a manner that raised administrative and extra territoriality problems. Section 5 of H.R. 831 is designed to avoid the problems of existing law. With this exemption of up to $1.2 million of gain for a married couple, the provision eliminates from its coverage all but the wealthiest. Although the tax is imposed on gains at the time the citizen renounces citizenship, there are provisions permitting deferral of payment of the tax if adequate security is provided. We would be happy to review this issue further, either now or in the future.

U.S. pension plan benefits are excluded from coverage, as well as up to $500,000 of U.S.—foreign pension benefits. U.S. real estate is exempt from this proposal.

Finally, citizenship will generally be deemed lost on the date of renunciation before a U.S. Government official or in the happening of other events, whichever occurs first.

Enactment of this legislation will help assure continued respect for the fairness and equity of our income tax system. With the revenue dedicated to deficit reduction, section 5 of H.R. 831 sends an important signal of our continuing intent to reduce our fiscal deficit.

Madam Chair, this concludes my statement. I will be available to answer any questions that the Subcommittee may have.

[The prepared statement follows:]

STATEMENT OF
JOSEPH H. GUTTENTAG
INTERNATIONAL TAX COUNSEL
DEPARTMENT OF THE TREASURY
BEFORE THE SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

Madame Chair and members of the Subcommittee, I am pleased today to testify in support of Section 5 of H.R. 831, which requires individuals who renounce their U.S. citizenship to face their tax responsibilities. My testimony is limited to section 5 of H.R. 831 as approved by the Senate and is generally similar to part of the Administration's proposal.[1] The proposal is designed as an improvement of similarly targeted provisions of our tax law that have been in affect for almost thirty years.

If a U.S. citizen relinquishes his or her citizenship, property held by that person would be treated as sold at fair market value immediately before such expatriation. Property treated as sold would include all items of property that would be included in the individual's gross estate under the Federal estate tax rules as if such individual were to die on the date of expatriation. In addition, certain trust interests would be subject to the new rules. In this regard, the bill provides that a beneficiary's interest in a trust is determined based on all the facts and circumstances.

The proposal contains important exceptions. First, gains up to $600,000 would be exempt from tax. Second, United States real estate and interests in certain retirement plans would not be treated as sold. Under the Senate bill, with IRS approval and appropriate security, taxpayers could defer the payment of tax on any asset for up to ten years. The tax would be effective with respect to citizens who relinquished their citizenship on or after February 6, 1995. For this purpose a person generally is considered to relinquish his citizenship on the first date on which the individual gives notice to a U.S. government official.

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[1] The Administration's proposal would also apply the proposed tax regime to a long-term resident, defined as an individual who has been a lawful permanent resident of the United States (i.e. a "green card" holder), other than an individual who was taxed as a resident by another country under treaty tie-breaker rules, in at least ten of the prior fifteen taxable years. A "green card" holder would be taxed when he or she ceases to be subject to U.S. tax as a resident.

Because of the exceptions and conditions described above, Treasury estimates that every year approximately two dozen very wealthy taxpayers with substantial unrealized gains would be subject to the proposed rules. The revenue generated by section 5 of H.R. 831, as passed by the Senate, is dedicated to deficit reduction.

The Administration supports the proposal because we believe that all U.S. persons should pay their fair share of U.S. tax. Our existing laws generally subject individuals to tax when assets are sold or when the individual dies. Certain wealthy people have found that they can completely avoid paying U.S. tax on their gains and generally avoid substantial further U.S. tax, by renouncing their U.S. citizenship. Because of the costs of obtaining another nationality and other transaction costs, renouncing U.S. citizenship to avoid tax is generally only a viable option for the wealthiest Americans.

Although recent publicity has focused on expatriations by super-rich Americans, the problem of tax avoidance by renouncing citizenship is not new. The United States first enacted expatriation tax rules in 1966 as part of the Foreign Investors Tax Act. The 1966 Act was intended to spur foreign investment in the United States by reducing U.S. tax on activities of foreign investors. Section 877 was adopted as part of this overhaul because Congress was concerned that the new rules to encourage foreign investment might also encourage U.S. persons to save taxes by surrendering their citizenship. H.R. Rep. No. 1450, 89th Cong., 2nd Sess. 22 (1966).

Under current section 877, a special taxation regime applies to a U.S. citizen who renounces his or her citizenship unless the loss of citizenship did not have as one of its principal purposes the avoidance of tax. This special regime applies for 10 years after expatriation. It subjects certain assets that produce U.S. source income to tax at graduated U.S. rates as if the person were still a U.S. citizen. Thus, taxing U.S. persons who abandon their U.S. citizenship is an accepted and long-standing part of our law.

The United States is not the only country in the world to enact rules to prevent expatriate tax avoidance. Other developed countries have enacted tax legislation to combat tax avoidance by expatriation. A brief summary follows. In 1971, Canada enacted a provision that treats a Canadian resident taxpayer as having sold all of his capital assets at their fair market value when he relinquishes his residence. In 1992, the Canadians reviewed this provision, and decided to expand it to apply to all assets (not just capital assets) that are owned by the departing resident. Australia also enacted a provision similar to the Canadian rule. In 1971, Germany enacted a rule that requires long-term residents of Germany who terminate their German residence to pay tax on a deemed disposition of 25 percent ownership interests in German corporations. Other countries have enacted different approaches to deal with the same problem. Countries that continue to tax former residents under special rules include Denmark, Sweden, the Netherlands, Norway, and Finland. Thus, it is accepted in the international community that a country may enact special anti-abuse rules to address the problem of departing taxpayers. The tax systems described above are more limited than the current proposal as they apply when one of their citizens decides to live in another country. A tax incurred when renouncing citizenship only

applies when a citizen gives up citizenship and not when a citizen just decides to live overseas. Let me emphasize that such a tax is not imposed when taxpayers leave temporarily or permanently. Travel abroad triggers no tax.

The Treasury Department has recently taken a close look at this area and concluded that section 877 needs to be overhauled. As a result of this review, the President's fiscal year 1996 budget contains a proposal to revise section 877.

The need for changes is based on several considerations. First, under existing rules, U.S. tax is triggered only if the expatriate had a tax avoidance motive. This tax motivation requirement is subject to abuse because it is often difficult to determine whether someone had a principal purpose of tax avoidance. Consequently, in practice it has been difficult to sustain a determination that an individual should be subject to tax under section 877. A similar change was made in 1984, when Congress deleted from the Code a provision that required a tax avoidance intent before tax would be imposed on certain transfers involving foreign corporations.

Second, existing law only applies to certain U.S. source income. This standard is subject to abuse because taxpayers may be able to convert U.S. source income subject to the tax under current section 877 to foreign source income that is not subject to the tax. We understand that practitioners advise their clients on ways to accomplish this conversion in a manner that purports to avoid section 877.

In addition, the U.S. source restriction of current law is inconsistent with the normal rule that U.S. citizens should be subject to tax on their worldwide income, whether from U.S. or foreign sources. However, existing section 877 allows former citizens to earn foreign source income without paying U.S. tax.

Third, existing expatriation rules are very difficult to enforce. The requirement of current law that the imposition of the tax must wait until the property is actually sold requires the IRS to monitor transactions that occur long after an individual relinquishes his citizenship, and is usually living overseas, and therefore imposes an undesirable extraterritorial effect.

Section 5 of H.R 831, as passed by the Senate, addresses the basic issues raised by existing section 877. The proposal taxes appreciation over $600,000 without regard to tax motivation. In addition, the tax applies to all gains, not just U.S. source gains. Finally, the tax would be much simpler to administer and enforce than the current law.

Some have raised concerns about the ability of taxpayers to pay a tax on their illiquid assets if they choose to expatriate. We believe these concerns can be adequately addressed. We support the changes made by the Senate that would allow taxpayers up to ten years to pay the tax. In most cases, a ten-year extension should be adequate time to pay any tax. This provision is based on an existing rule that extends the time that is normally given to pay estate taxes on illiquid assets. Concerns have also been raised about the appropriateness of taxing interests in trusts, particularly remote or contingent interests. The proposal determines trust ownership on

the basis of all the facts and circumstances. Thus, a taxpayer may show that he or she has no interest in a trust even if he or she is a potential beneficiary of the trust. The Senate Finance Committee elaborates on this rule: "It is intended that such regulations disregard de minimis interests in trusts, such as an interest of less than a certain percentage of the trust as determined on an actuarial basis, or a contingent remainder interest that has less than a certain likelihood of occurrence." Of course, payment of any portion of the tax due attributable to the trust interest could be extended as described above. If, however, a taxpayer is unable to pay the tax within that period, pursuant to current authority under the Code, the Internal Revenue Service may permit further deferral of the payment of tax under appropriate agreements. We believe that this combination of procedures should resolve difficulties of the relatively few taxpayers who would ever be subject to the provisions and avoids inserting elaborate complicated rules of limited application into the Code. We are willing however, to review this issue further, now or in the future.

We believe that the Congress has the authority to enact this bill. In 1920, the Supreme Court in *Eisner v. Macomber*, 252 U.S. 189 (1920), held unconstitutional an income tax imposed on stock dividends because the taxpayer had not yet realized a gain. However, the Supreme Court thereafter retreated from creating a constitutional requirement for realization. In 1940 the Court held in *Helvering v. Bruun*, 309 U.S. 461 (1940), that a landlord realized gain when he repossessed leased land on which the tenant had erected a building that added about $50,000 to the value of the property. A few months later, the Court ruled in *Helvering v. Horst*, 311 U.S. 112 (1940), that accrued interest on certain negotiable interest coupons should be taxed to the person that gave the coupons away. In that case, the Court demoted the realization concept from a constitutional principal by describing it as a rule "founded on administrative convenience."

More recently, other provisions of the Internal Revenue Code that tax gains prior to realization have been held to be constitutionally valid. These provisions include the foreign personal holding company provisions, the subpart F provisions, and the mark-to-market rules of section 1256. The Second Circuit considered the foreign personal holding company rules in *Eder v. Commissioner*, 138 F.2d 27 (2nd Cir. 1943), and found that Congress intended to attack "incorporated pocketbooks," and that this purpose was valid and constitutionally permissible. In a later case upholding the Subpart F rules, the Second Circuit said that the constitutional argument "borders on the frivolous." *Garlock v. Commissioner*, 489 F. 2d 197, 202 (2d Cir. 1973), cert. denied, 417 U.S. 911 (1974). More recently, the Ninth Circuit upheld the validity of section 1256 rules stating "section 1256 is neither arbitrary, capricious, nor confiscatory and is a proper exercise of Congress' constitutional power to tax." *Murphy v. U.S.*, 992 F.2d 929, 931 (9th Cir. 1993).[2]

Finally, the constitutionality of existing section 877 has been upheld by the courts. *Di Portanova v. U.S.*, 690 F.2d 169 (Ct.Cl. 1982). In another case involving expatriation, the Tax

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[2] Although the court upheld the constitutionality of section 1256 on due process grounds, it explicitly declined to address the realization issue.

Court held that "the taxing power of Congress . . . is exhaustive and embraces every conceivable power of taxation." *See Dillin v. Commissioner*, 56 T.C. 228, 241 (1971).

We believe that the power to tax income extends to the power to prevent taxpayers from rearranging their affairs to avoid tax on unrealized appreciation. *See* Bittker, Federal Taxation of Income, Estates and Gifts para. 5.2 at Id. at 5-20 (1989). A reasonable opportunity to impose and collect the tax on appreciated assets is when the U.S. citizen gives up his or her citizenship. Therefore, the tax imposed should be seen as neither arbitrary, capricious, nor confiscatory and as a proper exercise of the constitutional power to tax.

Let me next address the issue of whether the proposal is consistent with international human rights and the Jackson-Vanik amendments to the Trade Act of 1974. A memorandum prepared by the Department of State explains why this tax provision is not inconsistent with human rights obligations of the United States under international agreements and customary international law, and is submitted for the record. In brief, fundamentally the right to emigrate is the right to leave physically the territory of a State. That right is not affected in any way by the proposal. The proposal would not tax the physical departure from the United States, rather it would impose tax at the time of renunciation of United States citizenship.

Finally, regarding our treaty obligations, the proposal is consistent with our tax treaties since the United States reserves the right to tax its citizens and certain former citizens.

We believe that Americans who avoid their tax responsibilities by expatriating should not be rewarded. Instead, they should be asked to pay tax that U.S. citizens will pay sooner or later.

Madame Chair, this concludes my remarks. I would be pleased to answer any questions that the subcommittee may have.

Chairman JOHNSON. I thank you, Mr. Guttentag.

Is it true that regulations have not been issued for current statutory rules regarding U.S. citizens that renounce their U.S. citizenship?

Mr. GUTTENTAG. No regulations have ever been issued over the last 30 years under that section.

Chairman JOHNSON. If expatriation is a major tax avoidance problem, why hasn't the Clinton administration, and why haven't other administrations, issued regulations?

After all, they would only be implementing current law.

Mr. GUTTENTAG. Section 877 has not been—has not worked since its inception, and it was felt that regulations would not provide a means of making an effective provision out of that because of the defects in it. It has proven ineffective in solving the problem for which it was intended.

Chairman JOHNSON. So you would say that the regulations would not overcome the defects in the law?

Mr. GUTTENTAG. That is right.

Chairman JOHNSON. Can you please tell the Subcommittee how many U.S. citizens gave up their citizenship in 1994, 1993, 1992, 1991 and 1990?

Mr. GUTTENTAG. These figures as supplied by the Department of State reflect that in 1990, there were 571 citizens giving up their citizenship; 1991, 619; 1992, 556; 1993, 697; and last year, 1994, 858.

Chairman JOHNSON. How many of those that gave up their citizenship gave up their citizenship for tax motivated reasons in those years?

Mr. GUTTENTAG. We don't have any way of knowing that, Madam Chair. There have been very few cases brought and actions brought under section 877, and of course, we don't have any idea what the intention was of these several hundred people.

Chairman JOHNSON. But, Mr. Guttentag, how do you get revenue estimates for this if you have no idea what part of the 858 last year would be exempted under your bill and how many would be caught in that net? I mean, you must have some information about this or you couldn't have made estimates of the revenue impact.

Mr. GUTTENTAG. Yes. Our revenue estimates for the proposed legislation I believe made the assumption, at least on the Treasury side, that the present 877 was ineffective and did not raise any substantial revenue.

Chairman JOHNSON. So you do not expect this change in the law to raise any substantial revenue?

Mr. GUTTENTAG. I am sorry?

Chairman JOHNSON. So you do not expect the change you are proposing to raise any substantial revenue?

Mr. GUTTENTAG. The change in the law will raise substantial revenue.

Chairman JOHNSON. What I am asking you is, on what do you base that judgment, that revenue estimate, if you know that the current law is ineffective? You know that last year there were 858 renunciations, but you do not know what percentage of those renunciations were for the purposes of avoiding taxes.

Do you know what percentage of those renunciations would have involved assets valued at less than $600,000?

Mr. GUTTENTAG. No, we do not. We do not know, but we are basing our revenue estimate on the proposed legislation which does not require an intent to avoid tax.

Chairman JOHNSON. All right. Do you know then what percentage of the 858 involved estates valued at less than $600,000?

Mr. GUTTENTAG. No, we do not.

Chairman JOHNSON. How can you estimate what your revenue is going to be since they would all be exempted from this law?

Mr. GUTTENTAG. We make these estimates based on our revenue estimators' calculations based on various kinds of evidence which they have as to the number of people who may leave the United States, the number of people who are going to stay, who are in the category of paying high taxes and therefore have high-value assets, and their continued payment of taxes, plus those who would leave the country and pay taxes at the revenue estimate, because it includes people who, aside—if this legislation is not enacted, who would leave the United States and therefore reduce revenues which would otherwise be selected.

Chairman JOHNSON. You may remember that a couple of years ago—I think it was about 1991—this Committee entertained a proposal that imagined that we could collect something like $30 billion by taxing the income of foreign companies the same way we tax income of American companies. We had this extraordinary estimate and we all frankly got very excited about that. That sounded like an easy way to get billions of dollars. When the dust settled, there wasn't any new money there.

Now, I am concerned that we might do this and find no new money there, and I think you are obliged in proposing a change in current law to provide us with some better information about the 858 cases last year, or the 697 the year before, because we need to understand what percentage of these people would have been exempted by your proposal and on what basis you suggest that your proposal is going to bring in $1.4 billion from probably a very small number of cases.

Nothing that you have said in response to my question indicates to me that you have a very concrete grasp of what number of cases are going to pay, how much they are going to pay or why you think they are going to pay that dimension of dollars.

So if you would like to enlarge on any aspect of your preceding comments to make it clearer to me why you think your revenue estimate should be considered as possible, I would be happy to hear those comments.

Mr. GUTTENTAG. Yes, I believe the $1.4 billion estimate was that of the Joint Committee, Madam Chair. I think our—the Treasury estimate was higher than that. The Joint Committee estimate did not include resident aliens who would be subject to tax under the administration proposal. That accounts for part of the difference between our estimates. So while they were different, they are both substantial in amount.

But I would be glad to—these—revenue estimating is a—quite a science, and I do not pretend to be an expert or even knowledgeable in that area. We rely on our revenue estimators, and they

have made these estimates based on collecting facts from various sources. Most of it involves very few people in very high income categories, and if anything, I think they were reasonably conservative.

Chairman JOHNSON. Thank you.

I am going to yield at this time to my colleague, Mr. Ramstad.

Mr. RAMSTAD. Thank you Madam Chair. Mr. Guttentag, let me apologize, I was addressing my questions and opening remarks to Mr. Samuels, not realizing you were in fact pinch hitting. I thought both of you were appearing today. I had a list of witnesses with Mr. Samuels' name on it, but now I can ask you the questions.

I share the Chair's concerns about the revenue projections generated by this tax. You know, the last thing we need around this place is another enforcement nightmare for the IRS that costs the American taxpayers more than revenues would bring in. I think conceptually it is certainly hard to argue that taxing U.S. citizens who give up their citizenship for tax avoidance is not the right thing to do. I think we all agree with that; that it should be the public policy of this country to prevent expatriate tax avoidance.

Let me just ask you a couple of questions for my understanding.

Now, with current law, as your testimony stated, the government must prove intent, that is, intent of tax avoidance.

Mr. GUTTENTAG. That is correct, yes.

Mr. RAMSTAD. So we are trying to make it more of an absolute liability standard?

Mr. GUTTENTAG. Yes. Intent would be irrelevant.

Mr. RAMSTAD. Another reason for the administration's recommended change. As I understand, the current law only applies to certain U.S. source income. You are concerned about the abuses there?

Mr. GUTTENTAG. Yes. The present law applies to U.S. source income and doesn't take into account gains which may be realized from foreign assets; and since U.S. citizens are taxed on a worldwide basis, we believe this proposal should apply on a worldwide basis.

Mr. RAMSTAD. Well, I think before we move this legislation, we should get those revenue estimates about which the Chair probed. I would like to hear a little bit more to ease my concerns as to the cost of enforcement because it seems to me that we could have another enforcement nightmare here that is going to end up costing more than it brings in, and I think that is the last thing we need.

Mr. GUTTENTAG. Well, we would be glad to review those and provide you with additional information.

Let me say that it is my understanding that the way the income was calculated was primarily based on the present keeping—presently—present taxpayers in the United States who might otherwise depart in order to avoid tax. So that we know, based on evidence in the press from public and other media, that certain individuals have left the United States. From that, we can extrapolate as to what would happen under the—this provision, as it would pass, how many of those people would still leave and pay the tax, how many would stay and still be subject to regular U.S. tax as all of us are.

In my discussions with our revenue estimator at Treasury, telling him that I was going to be here this morning, he again confirmed to me that he believes that his estimates are reasonably conservative, and I think the Joint Committee revenue estimates speak for themselves, but they appear to be even more conservative than ours.

Mr. RAMSTAD. Thank you, Mr. Guttentag. You are a very capable pinch-hitter for Mr. Samuels, and I sincerely hope you will take that message back to the White House as the only administration representative here today, or at least the first one that I have seen this week, that we all need to tone down the rhetoric.

Mr. GUTTENTAG. I certainly will.

Mr. RAMSTAD. Thank you, Madam Chair.

Chairman JOHNSON. Thank you.

Mr. Hancock.

Mr. HANCOCK. Thank you very much. You know, this whole thing of people fleeing to avoid paying taxes has been going on throughout history when the citizens start feeling that government is excessive in its taxation. For instance, the Mayan empire, they collapsed as a result of their citizens just disappearing into the jungles because of excessive taxation. In fact, I would recommend a book to you and everybody over at the Treasury, if you haven't already read it, called "For Good Or Evil: The Impact of Taxes on the Course of Civilization," and that may be the area that we are into now.

If, in fact, we had a reasonable capital gains tax and a reasonable estate tax, these people wouldn't have any reason to leave the country; am I correct in that? If, in fact, your judgment is right that they are leaving for the express purpose of avoiding taxes, if in fact we had reasonable taxes on these people, then they wouldn't want to leave—it wouldn't make any difference; am I correct? There would be no reason for them to leave?

Mr. GUTTENTAG. Well, based again on our analysis of those who do leave, it appears that many of them leave not for the purpose of subjecting themselves to some other tax regime, but most of them leave under circumstances under which they or their estates will not be subject to any meaningful taxes in the future.

So it does not appear to us that the level of capital gains tax or the level of taxes here in the United States is a major consideration. Our taxes here are generally comparable to those in most of the developed countries of the world and the expatriating citizens usually subject themselves to the tax regime of the country.

Mr. HANCOCK. You are telling me that our estate taxes and our capital gains taxes are comparable to other developed countries'? Japan, for all practical purposes, doesn't even have a capital gains tax. I am not too sure about the estate tax. Did I hear you right?

Mr. GUTTENTAG. They have—Japan and the United States, for example, I think—and again, this is not my field—are generally at about the same level of taxes as a percentage of gross domestic product, and their tax rates are not that dissimilar.

Mr. HANCOCK. Let me ask you another question.

As an American citizen, let's say I have got a lot on the ball, which a lot of people would question, but let's, for example, say it looks like I am going to make a lot of money. If I gave up my citi-

zenship before I made the money, I could avoid this tax. One person that has citizenship already down in the Bahamas or someplace, investing in the United States, becomes a billionaire, another one living with a citizenship in the United States becomes a billionaire; they will be taxed differently, right?

Mr. GUTTENTAG. That is correct.

Mr. HANCOCK. So what we are saying is that if you are a citizen of the United States, you need to renounce your citizenship before you become wealthy instead of after.

Mr. GUTTENTAG. Right. That is correct.

Mr. HANCOCK. If an individual happens to come from a family that has a lot of money to invest, the best thing to do is become a citizen of another country before he makes his money; isn't that kind of a disadvantage to the American citizen?

Mr. GUTTENTAG. Well, I know you don't intend at all to speak lightly about the act of giving up your citizenship; and we can see from the relatively few people that do that, it is a very treasured thing to most.

Mr. HANCOCK. I understand that you are talking about it being a buried treasure. There is no question about it. But you are also talking about generating an additional $1.5 million a year as a result of this expatriate law that we are considering.

Now, how are you going to—how many people are going to show up to do that? I mean, you are going to run out of billionaires pretty quickly if, in fact, they started doing it, in my judgment. And here again, I need to talk to some experts in this area because this approach of giving up your citizenship is just recently starting to be suggested by tax advisors to extremely wealthy people in their estate planning.

Now, they have been talking for a long time about moving assets out of the United States. In fact, we are even to the point within the United States that people are changing their State of residence because of the differential between, say, the State of California and the State of Florida. This has been going on ever since the Babylonians. So I certainly cannot support any tax law that gives a foreign citizen an advantage over an American citizen, and that is basically what we would be talking about doing here.

Mr. GUTTENTAG. I think that the U.S. citizen has many advantages. First, giving up the citizenship with the hope that you are going to be earning this money in the future, that may, of course, never happen and you have given up your citizenship.

Mr. HANCOCK. Well, I was being a little facetious when I suggested that. But the fact remains, two people, equal, one of them being a citizen of Peru, and one being a citizen of the United States, if they should decide to give up their citizenship in the United States, as far as dollars are concerned, that individual, when his death comes around or he pays his taxes, if he still has his citizenship in the United States, is going to pay a lot more than that individual who made the same amount of money doing the same thing, but does not have a U.S. citizenship, but made his money in the same place, in the United States.

Mr. GUTTENTAG. Well, the administration proposal would tax the long-term resident, immigrant in the United States, the green card

holder, under the administration proposal if that person was here more than——

Mr. HANCOCK. Sir, if you are just investing money in the United States, you don't have to have a green card.

Mr. GUTTENTAG. No.

Mr. HANCOCK. You know, you can make lots of money investing in the United States.

Mr. GUTTENTAG. And we are putting no restrictions on that kind of investment.

Mr. HANCOCK. Well, you are making my point. If I am an American citizen, and I invest in the United States and end up with a lot of money, I am going to be taxed—I am going to pay much bigger capital gains and estate taxes than I would if I was a citizen of England investing here in the United States.

Mr. GUTTENTAG. That is right, and that is the way our tax laws work. They are generally based on two factors, one, the source of your income. We pay tax based on the source. The rest of the tax is based on where you reside. Only in the case of the United States do we also tax based on citizenship and where you reside.

If that person can live in some other country, be a national of that country and be enabled to make money in the United States, he is free to make that money. He does not have the benefits of U.S. citizenship, which we consider important. He is not allowed to live here permanently in the United States. That is true for people all over the world, and there could be a person overseas.

Mr. HANCOCK. And the reason we do that is because we want the investment capital coming into the United States.

Mr. GUTTENTAG. Right.

Mr. HANCOCK. Now, why do we tax people that have accumulated investment capital to the extent that they have got to give up their citizenship so we can retain the investment capital in the United States? I mean, something just doesn't sound quite right to me.

We want the investment capital, but if a citizen of the United States makes it, then we want to tax him, say we don't have the investment capital, then the government ends up with the money to throw away. Thank you. I still think you ought to read this book.

Mr. GUTTENTAG. All right. I certainly will.

Chairman JOHNSON. Mr. Guttentag, your response to my colleague's question that you didn't think it would dampen foreign investment strikes me as very interesting. I can't imagine that that would be so, but it is just a matter of judgment. But the administration's proposal applies to noncitizens. If I were a noncitizen watching this, I would think, what is the next big source of new income? I want it clear in the record that that is simply a matter of judgment and not a matter of fact; and I think we are going to hear testimony later today that it is a matter of fact that Asian immigrants are choosing Canada over the United States, and this kind of action by the United States is certainly going to influence their thinking, at least in my judgment; and I understand that that also is just a matter of judgment. But we are, for whatever reason, seeing some of the most talented immigrants choosing other nations to immigrate to.

I want to get back to my issue of regulations.

Mr. GUTTENTAG. Yes.

Chairman JOHNSON. What is the key change between current law and the law you are proposing that leads you to believe that you will be able to implement regulations that will implement this law and gain the revenue that you suggest is there to be gained?

Mr. GUTTENTAG. The key issue is that this tax that is being proposed would be imposed at the time the U.S. citizen—or the administration proposal, the long-term resident engaged in this expatriating act. And that would be the end of the tax regime for income tax purposes.

Under the proposal—under the legislation as it now exists, the United States imposes tax over a 10-year period when the former U.S. citizen may be living in various countries of the world creating conflicts with our tax treaty network. Assets are outside the United States; there is not even a way to monitor effectively the amount of income earned, as well as being able to convert U.S. source income quite easily to foreign source income and avoiding the tax net under present section 877.

Chairman JOHNSON. I see. Because you impose this at the time of termination of citizenship and collect all the taxes at that time——

Mr. GUTTENTAG. We would——

Chairman JOHNSON [continuing]. This can be more effective?

Mr. GUTTENTAG. Excuse me.

The legislation provides for an ability to defer tax under appropriate—defer payment of the tax under appropriate circumstances, which we think is important.

Chairman JOHNSON. OK. Now, given that, would you discuss how this law applies to trusts and particularly to contingent remainder interests?

Mr. GUTTENTAG. It would apply to trust interests which would be valued in accordance with standard valuation techniques. It would eliminate de minimis interests in trusts based on such valuation so as not to get involved where there is remote and—where there are contingencies, which are reasonably not to come into play, and would also provide—particularly useful in those cases where there was not immediate access to the trust funds—a means of deferring the tax.

Chairman JOHNSON. And so are you suggesting that it would not require somebody with an interest in a trust to convert that interest into income so that they could pay the tax? It would not require, in a sense, escape?

Mr. GUTTENTAG. Well, that would depend on the terms of the trust, whether it could be converted. It would depend on other assets that the citizen had. We would, of course, have to look at all of the assets and all of the gains involved in order to determine how the tax should and would be paid.

Chairman JOHNSON. I wanted to get some examples on the record to be sure that these are also the kinds of cases that would be affected.

Person A fled Cuba in 1959 and became a U.S. citizen. In 1999, Cuba becomes a democracy. A returns to Cuba and renounces his U.S. citizenship. A would be subject to tax under the administra-

tion's expatriation proposal on all assets he had accumulated and all income he had accumulated during his years here, correct?

Mr. GUTTENTAG. That is right, yes.

Chairman JOHNSON. B left Y, his native country, in 1957 because it was ruled by a communist government and he settled in the United States. He never obtained U.S. citizenship, but complied with all immigration laws. After the fall of communism, he returned to Y and decided to make Y his homeland. In 1998, B leaves the United States and returns to Y. B would be subject to tax under the administration's proposal, would he not?

Mr. GUTTENTAG. Yes, he would be.

Chairman JOHNSON. So caught in this net are going to be all those who came here fleeing communism, all those who may have come here because of the unsettled circumstances in the Middle East, all who came here because of the conflict and war in Ireland, and all those who came here for similar reasons from places all over the world and, in good faith, worked hard and developed some resources. And we are, under this proposal, going to then tax them at a level that we tax no other living citizen or noncitizen; is that correct?

Mr. GUTTENTAG. No. We would tax them as we would a U.S. citizen.

You are right, Madam Chair, we opened our doors here to these people. They came here. They took advantage of the U.S. economy, apparently to earn substantial wealth, otherwise they would not be subject to this tax; and if they decide to go home, all we are asking is that they pay U.S. tax on the gains they have realized while they have enjoyed our hospitality here in the United States.

Chairman JOHNSON. But, Mr. Guttentag, we are forcing them to treat things as a sale and so we are forcing them to accumulate cash assets to pay taxes at a time that normally we only do upon death, and in that regard, it can reduce the value of hard-earned assets in a way that we don't force on any other Americans. Wouldn't you say that is fair to say?

Mr. GUTTENTAG. Well, an American, of course, has to prepare also for death and those kinds of taxes and would, of course, in the future be able to prepare for this tax; and as I said, we do plan to have means available to defer the payment of tax to avoid that kind of hardship.

Chairman JOHNSON. I guess my point is that this is not necessarily going to fall on those who are motivated by tax avoidance. Many of the people who came here and worked hard were motivated by all of the motivations that have made America a great and strong country; and without question, this proposal is going to lay on them a burden that no other working American will ever experience. Is that not so?

Mr. GUTTENTAG. The—what we are—the working American who subjects his assets to tax by selling his assets and realizing the gains will, of course, pay tax during his lifetime. But this person who has come to the United States will be allowed to exempt the first $600,000 of gain, which is a substantial amount. That is not assets; that is gain realized during this period of time, 600,000 dollars' worth of gain. He will be able to—he will not have to pay tax on—presumably he would have a home in the United States or

other real estate in the United States. He would not have to pay any tax on that U.S. real estate. He would have, exempt, any money that he would have placed in pension funds for his benefit. So all of those assets would be free and clear of this proposed tax.

Chairman JOHNSON. My staffperson was clarifying for me your exemption for small business assets, which is very important, but if you have saved up and you have your own small business and you invest in stocks, you would be forced to sell them, possibly at a loss, in order to get enough money to pay this exit tax, would you not?

Mr. GUTTENTAG. There are administrative procedures presently in the Internal Revenue Code, Madam Chair, which do permit the deferral of tax collection by the Internal Revenue Service when appropriate security is given and good cause can be shown for—good reason for the deferral.

Chairman JOHNSON. My understanding of the Joint Tax Committee's estimate is that it is based on the assumption that this tax is heavy enough to discourage people from changing their citizenship and that their increase in revenue estimates is based entirely on the fact that people will not choose to make this decision. Is that the assumption behind Treasury's estimate of the revenue increases?

Mr. GUTTENTAG. I think Treasury's methodology and that of the Joint Committee are quite similar.

Chairman JOHNSON. So actually you are not anticipating that people will pay more taxes. You are anticipating that they will not choose to give up their citizenship.

Mr. GUTTENTAG. No. We are estimating that if this law is not passed, that these people will leave the United States and we will not collect that tax. If this law is passed, we will collect more tax than we would if the law is not passed. So we are just assuming that these people will leave the United States if the law is not passed, will give up their citizenship if the law is not passed.

Is that—I am sorry if I am not clear, Madam Chair.

Mr. HANCOCK. Madam Chairman, may I, with your permission?

Chairman JOHNSON. Yes.

Mr. HANCOCK. Are we making the assumption that if you pass the law, then these people will not leave the country, they will not give up their citizenship if the law is passed? Is that what your assumption is?

Mr. GUTTENTAG. Yes. Based on the information we have that the people who have left, the wealthy people who have left really have no interest in leaving the United States. They often spend a considerable amount of time in the United States after they give up their citizenship. They have family here, they have businesses here, that their real reason for leaving is tax avoidance, that if there is a price to pay for tax avoidance, they would stay here.

Mr. HANCOCK. Let me ask you a question then. If your assumption is correct, where is this $1.5 billion going to come from?

Mr. GUTTENTAG. Those people will remain here and would not—if the law is not passed, those people will give up their citizenship and we will not collect the——

Mr. HANCOCK. Wait 1 minute. Let's say we pass the law.

Mr. GUTTENTAG. Right.

Mr. HANCOCK. These people quit leaving the country and giving up their citizenship. Now where does the $1.5 billion increase in revenue come from?

Mr. GUTTENTAG. Well, we have people who are paying millions of dollars a year in tax. Those individuals would continue to pay tax in the United States.

Chairman JOHNSON. So there will be no increased revenue? They are paying it now and they are going to keep paying it?

Mr. GUTTENTAG. Yes. But if the law is not passed, there will be a decrease in revenue and that is considered a revenue gainer.

Mr. HANCOCK. Well, now, are you talking about income tax revenue?

Mr. GUTTENTAG. Yes.

Mr. HANCOCK. Or are you talking about estate tax revenue?

Mr. GUTTENTAG. Income and estate taxes both.

Mr. HANCOCK. Well, I still think, Madam Chairman, we get back to the question that a foreign citizen has a better opportunity to invest in the United States than an American citizen does. I mean, that is what it looks to me like.

Chairman JOHNSON. I am curious as to why the administration didn't focus primarily on those who do return after they have given up their citizenship and continue to do business. It seems to me that wouldn't be too hard to

monitor.

Mr. GUTTENTAG. We have thought about that.

Chairman JOHNSON. That is the real tax avoidance issue.

Mr. GUTTENTAG. That—in some cases, we can't define the situation with respect to all of these people. There are very—relatively few people who are involved in this situation. Many of them who do return, who have obtained U.S. citizenship or obtained a green card permitting them to live permanently in the United States, those people who have been subject to acts of foreign governments which have caused them to come to the United States, when they do have the opportunity to return, very often they keep their citizenship and green cards because of the uncertainty that they don't want to make—they want to make sure if something were to happen again, they would have the United States to return to.

Chairman JOHNSON. Certainly, but if they do that, they are not affected by this tax.

Mr. GUTTENTAG. They are not affected by this tax.

Chairman JOHNSON. If you are really interested in tax avoidance, why don't you go after those who forgo their citizenship but then return and continue to do business? That is the tax avoidance group of all the others. The groups that came from communist-dominated countries and so on and go back for other reasons, that is not really the group you are after. The group you are after are the ones who renounce their citizenship specifically to gain tax benefit.

Now, I would say that my colleague, Mr. Ramstad, pointed out that usually this happens when something has gone awry with the Nation's tax structure. Connecticut loses people every year because our tax structure takes more than people want to pay for seniors, and so people move when they reach 65 to other States. Now, we could fix that in Connecticut and we are trying to fix that.

So I am concerned that we are fixing this in a hostile way when maybe we ought to be fixing it in a positive way. That is one thing that concerns me.

But the other thing that concerns me is that by being overly broad instead of looking at the group that is exploiting our Tax Code, we set up our other people to be gone after by the IRS, and when this gets moving, what will the IRS' stance be in regard to transactions by these people in the months before they declare—just like we get into Medicaid; what happens in the 3 years before you become Medicaid eligible, or in the 5 years before.

So by writing too overbroad a law, you are creating a noose for a lot of innocent folks as well, and that is why we have an obligation to focus this law as narrowly as we can on the problem, and that is why it concerns me that of the numbers of people who renounced their citizenship last year, 858, you don't have any information you can share with me about either what the incomes of these people were, or what was their asset value.

You must know. We have all those records. So I would suggest that you get the Committee some better information. You run your computers overnight, get us back some better information on those folks so that we can see whether or not there is a way we can focus this law more effectively to go after people who are trying to, in a sense, take advantage of international differences in tax burden for their own benefit.

[The information was not available at the time of printing.]

Chairman JOHNSON. But I do worry about the breadth of this bill and particularly the breadth of this proposal for a Nation that has always valued immigration and that believes that opportunity carries with it also certain rights.

So I thank you for your testimony today and we will move on to the next panel.

Mr. GUTTENTAG. Thank you, Madam Chairman.

Chairman JOHNSON. The next panel is Robert Turner, Charles Stockton Professor of International Law, U.S. Naval War College, Newport, Rhode Island, on his own behalf; William Norman of Ord & Norman, Los Angeles; and Lawrence Heller, of Whitman, Breed, Abbott & Morgan, Los Angeles. We will begin with Mr. Turner.

Mr. Turner, if you will proceed.

Let me remind this panel, as well as the next, that your full testimony will be included in the record, and during your time of testimony, would you please summarize your testimony and comment in any way you care to in view of the foregoing discussion. Thank you.

Mr. Turner.

STATEMENT OF ROBERT F. TURNER, CHARLES H. STOCKTON PROFESSOR OF INTERNATIONAL LAW, U.S. NAVAL WAR COLLEGE, NEWPORT, RHODE ISLAND

Mr. TURNER. Thank you, Madam Chairman.

It is a great honor and a pleasure to be here this afternoon to discuss the human rights ramifications of the so-called exit tax in the Tax Compliance Act of 1995. As you suggested, I will submit my prepared statement for the record.

Before going further, I do have three caveats. One you have already mentioned, and it is very important to note that I was asked to appear before the Committee in my individual capacity and not on behalf of the Naval War College or any other group.

Second, also very important to me, I have absolutely no substantive expertise on tax law, and so to the extent you have questions in that area, I am going to have to leave those to your judgment as the real experts.

Finally, a point you also mentioned, we are I think all here on very short notice. I would like to have had more time to think about this, to do more research. That is all the more important, because there are a number of very distinguished international lawyers who take a very different position than the one I will present. All I would say is, consider the arguments I make on the merits and make your own judgments.

The basic human rights issues raised here are not new to me. Ironically, it was my pleasure to serve on the U.S. Senate staff in 1974 when the Jackson-Vanik amendment was passed, and I worked on that amendment as foreign policy advisor to Senator Bob Griffin of Michigan.

Before I get into a brief summation of the law involved, there is one point of apparent disagreement that perhaps it would be useful for me to identify and focus on briefly. The Office of the Legal Advisor of the Department of State, where I have many very close friends, and I have great respect for them; the Library of Congress Congressional Research Service; and others have tried to draw a distinction between the right to travel and the act of renouncing one's citizenship.

Underlying this distinction, apparently, is the view that there is no legal right of expatriation; that is, no right to renounce citizenship, and since this bill doesn't really stop travel, it only stops renouncing citizenship, they argue human rights law doesn't apply. I simply don't agree with this view.

First of all, having worked closely on the Jackson amendment, I can say that—at least for many of us—our concern involved all of the impediments to emigration and expatriation. Certainly we used the word emigration, but we were talking about the human right of citizens of the Soviet Union to make a permanent departure from that country, and to completely sever the citizen-state relationship as they move to Israel or any other country of choice to become citizens.

This was not merely a debate about travel in the sense of taking vacations to the Holy Land, but rather about making a permanent change of allegiance. I think most of us had in mind at that time not only emigration, but also expatriation.

Second, in response to those who have said that international law is not concerned with the right to renounce one's citizenship, I think they are mistaken. I will try to make that point briefly.

Finally, I would note that the Jackson-Vanik amendment passed unanimously in the Senate and overwhelmingly in the House, and one of the things that we were complaining about was something the Soviets called a "citizenship renunciation fee" of 500 rubles. The Soviets said, If you want to go to Israel, among other things,

you have to pay an extra fee for the purpose of renouncing your citizenship.

More importantly, however, the United States has argued for two centuries there is an international right of expatriation. Indeed, the core of the intellectual justification of the American Revolution was that such a right existed. The very first sentence of the Declaration of Independence, in fact, asserts such a right.

Since this proposal comes from the Treasury Department, it might be worth noting President Thomas Jefferson's June 1806 letter to then Treasury Secretary Albert Gallatin, in which Mr. Jefferson wrote: "I hold the right of expatriation to be inherent in every man by the laws of nature." I would note as an aside here that Jefferson viewed the law of nature as the first source of international law.

He goes on to say, "and incapable of being rightfully taken from him, even by the united will of every other person in the Nation."

Continuing, Mr. Jefferson wrote, "Congress cannot take from a citizen his natural right of divesting himself of the character of a citizen by expatriation." This view was shared by Secretaries of State John Marshall, James Madison, James Monroe and many others; and indeed, also implicitly by the first Congresses, because when they passed naturalization laws, they required would-be American citizens to renounce their citizenship to other governments, implying in the process there was a right to do that.

One can argue that the War of 1812 was in no small part fought over this right, because the British were impressing former British subjects who had become naturalized American citizens when they were found on the high seas, and we thought that was an infringement of their international duty to us and the right of our citizens.

The Congress in 1868 enacted an act concerning the American rights of citizenships in foreign states which provided, in part, "the right of expatriation is a natural and inherent right of all people, indispensable to the enjoyment of the rights of life, liberty and the pursuit of happiness."

This act, by the way, was enacted during a dispute we were having—one of many—with Great Britain over their principle, "once an Englishman, always an Englishman." The idea was that once you were an English subject, even if you subsequently took other citizenship, you still were subject to the Crown.

Two years after this 1868 enactment, Great Britain finally abandoned this claim and recognized that people who had accepted other citizenship were aliens, and in so doing, it contributed to the development of the customary international law in this area.

Now, let me turn just very briefly to the relevant international legal documents that give us our legal rules. The International Covenant on Civil and Political Rights, which entered into force in March 1976, and was ratified by the United States with the advice and consent of the Senate in 1992, provides in article 12 that, "Everyone shall be free to leave any country, including his own."

It then said, "The above-mentioned rights shall not be subject to any restrictions, except those which are provided by law and are necessary to protect national security, public order, public health, or morals, or the rights and freedoms of others."

Now, certainly the right embodied in article 12, which I believe should be construed broadly to include the right not only to emigrate, but the right to change nationality in that process, the right to renounce citizenship, is not an absolute right. It is a fundamental right, but not an absolute right.

For example, citizens who are accused or are being tried for criminal activity or have been convicted of crimes—serious crimes—may be kept behind to serve their punishment and complete the trial; and certainly it is also clear that a State may require a citizen to pay any normal tax obligations or other public debts.

It strikes me that a key issue here is whether or not this is in fact a normal tax obligation that would be applicable to all citizens irrespective of their wish to emigrate. If it is instead a special requirement on individuals because of their desire to emigrate—and indeed I was troubled by the Treasury Department testimony just a few moments ago, which seemed to admit that a purpose of this law is to keep people from leaving. He said, Treasury's expectation is that people will not go out and pay this tax, but rather they will remain U.S. citizens—I have to say that troubles me.

If this is a special requirement that would not otherwise fall on these people at that time, then it strikes me that the government has the burden to establish under the covenant that the law is necessary to protect "national security, public order, public health or morals, or the rights and freedoms of others."

I would note in this connection that the Library of Congress Congressional Research Service memorandum on this issue tried to get around this by saying the term "public order" is "roughly analogous to the concept of public policy and likely includes such notions as economic order." However, during the drafting of article 12, an effort was made to broaden this list to include the terms: General welfare and economic and social well-being, and those provisions were rejected as being too far reaching.

Under the principles of treaty interpretation embodied in the Vienna Convention on the Law of Treaties, these "travaux préparatoire," the "preparatory works," could be considered in the case of ambiguities, and I believe it would be very hard to argue that the convention allows that broad an interpretation, given the fact that such language was expressly rejected.

Now, let me talk just very briefly about customary international law. Perhaps the most important written document that contributes to the development of customer international law in this area is the 1948 Universal Declaration of Human Rights. To be sure, when the universal declaration was passed as a U.N. General Assembly resolution in 1948, it was not intended to be legally binding; but there is a very strong consensus today, I would argue, that the declaration is considered reflective of binding customary international law.

The United States would have no prayer of arguing otherwise, given the fact that we have enacted statutes in this area that embody a very clear rule on this. Article 13 of the universal declaration provides that, "Everyone has the right to leave any country, including his own." Given particularly the suggestion that there is no right to renounce citizenship, I would note that article 15 says,

"No one shall be arbitrarily deprived of his nationality, nor"—and this part is important—"nor denied the right to change his nationality."

It strikes me that this is clear language, and it strikes me that, in particular, given the strong history of the U.S. Congress and American Secretaries of State dating back to our very first Secretary of Foreign Affairs, Thomas Jefferson, embracing the view that there is an inherent human right of expatriation, I just don't believe that it is wise to try to pretend we are not violating the law by pretending there is no such right.

Before closing, let me just briefly discuss the Jackson-Vanik amendment of 1974, a very important statute that, as I mentioned, was unanimously passed in the Senate and overwhelmingly passed in the House. It resulted from a series of measures the Soviet Union placed primarily in the way of Soviet Jews who wished to emigrate and change their allegiance to the state of Israel. The statute was broader than that, but its real underlined purpose was probably especially aimed at protecting Soviet Jews.

Among other impediments, Moscow imposed a diploma tax, and the argument was fairly simple. The argument was that these doctors, scientists, or otherwise technically skilled people had received a free education because Moscow assumed that they would be in the country for many years to come, and thus they would pay it back through their service to the State. But if they want to take that special benefit they have received from the State and move to Israel, the U.S.S.R. was going to require them to pay, on a sliding scale, depending on the skill level and how long they had been practicing, of between $5,000 and $25,000. In addition to that, there was also a 500 ruble "citizenship renunciation fee," that they also had to pay before they could leave.

As enacted into law, the Jackson-Vanik amendment would have denied most-favored-nation trade status to any nonmarket economy state, which, among other things "imposes more than a nominal tax on emigration for any purpose or cause whatsoever."

Again, certainly when I used the word "emigration" in those days, I was thinking in terms of the process of a Soviet citizen leaving the Soviet Union, moving to Israel, becoming an Israeli citizen, and severing all legal relationships with the Soviet Union.

Although I would acknowledge there is a technical difference between emigration and expatriation, I think most people who used the word in those days were considering both a part of the process. Second, Jackson-Vanik applied to any State that "imposed more than a nominal tax as a consequence of the desire of such citizen to emigrate to the country of his choice."

Now, that strikes me as being very difficult language to reconcile with the language in this tax bill. What we are saying is, when you declare your desire to emigrate or to expatriate, if you will, we are then imposing a tax—and I gather this tax will average out to something like $40 million a person, so it would be awfully hard to argue that is just a "nominal" tax. I note that the Library of Congress Congressional Research Service characterizes this proposed tax as an "expatriation tax," and I find it just too similar to the Soviet "citizenship renunciation fee" to be real comfortable with the distinction. Both, after all, are premised on the idea that the

citizen has received a benefit in one State, wishes to leave and take that benefit with him, and that he should pay the State before he goes for the fair value of that benefit.

Now, let me emphasize, it is not illegal under international law to require someone who wishes to emigrate or expatriate to pay a normal tax obligation. That is clear. Nor would it be illegal for the United States to tax unrealized capital gains annually—just to have a rule that says, every year we tally up, and whatever property anyone owns that has increased in value, we will estimate the price and make them pay that.

Similarly, it would not be illegal for the Soviets to have charged a fee for providing an education to their citizens. The legal issue arises when this is not done across the board, but rather where people who wish to leave their country and move permanently to another country are treated less favorably than other citizens by virtue of that fact.

Madam Chairman, again, I want to emphasize that honorable people can and do disagree on this issue. I have been working on it specifically for maybe 10 days now. I may change my own mind as the debate goes on. You will hear from other very respected witnesses later today on this issue. It strikes me that it is not an easy call. I think you have a difficult task.

But if I could in closing inject a personal note into the debate, I would urge you to move cautiously if you have any significant doubts about this provision's compatibility with international law. Because candidly, when I balance the importance of upholding international standards of human rights on the one hand against the possibility of coming up with a few billion dollars to help pay off the deficit, my personal values come down on the side of human rights every time.

Madam Chairman, that concludes my prepared testimony. I would be happy to answer questions at the appropriate time.

[The prepared statement follows:]

Prepared Statement of
PROFESSOR ROBERT F. TURNER
Charles H. Stockton Professor of International Law
U.S. Naval War College
before the
Subcommittee on Oversight
of the
House Ways and Means Committee
27 March 1995

MADAM CHAIRMAN, it is a great honor and a pleasure to appear before the subcommittee this afternoon to explore the human rights ramifications of the so-called "exit tax" contained in Title II of H.R. 981, the "Tax Compliance Act of 1995."[1]

Before turning to the merits of the issue, I would like to make three caveats in connection with my appearance here today.

First of all, as your letter of invitation of last Thursday made clear, I was "invited to testify in [my] individual capacity, and not as a representative of the U.S. Naval War College."[2] Although I currently occupy the Charles H. Stockton Chair of International Law at the Naval War College while on leave of absence from the University of Virginia's Center for National Security Law, my appearance is unconnected with either of those relationships. Any similarities between the views I express and those of the War College, the Navy, the University of Virginia, or any other institution or organization, are purely coincidental.

Secondly, I want to stress from the start that I have absolutely no expertise on the substantive issue of tax law. I will therefore have to pass on any questions you might wish to raise predicated upon such a knowledge; and I certainly don't rule out the possibility that a thorough understanding of tax law might produce a different conclusion than the one I have tentatively reached when the relevant rules of International Law are applied to the statutory language now under review.

Finally, since my invitation to testify was not extended until late last week—when I returned to the War College after testifying before the Senate Finance Committee on this same issue—I have been working under time pressures and have found it necessary to use my Senate testimony as a starting point for this afternoon's prepared statement.

The basic human rights issue raised here is not new to me. Ironically, I believe I first looked at the "right of emigration" professionally more than two decades ago when the Jackson-Vanik Amendment[3] came before the Senate while I was the senior foreign policy adviser to Senator Robert P. Griffin of Michigan. I don't believe the pressures of time have prevented me from accurately setting forth the basic legal rules by which this statutory provision should be judged. But both because of my lack of tax expertise and the lack of time to research the issues more thoroughly, I am less certain of my tentative conclusions.

I do not appear before you this morning for the purpose of either supporting or opposing the so-called "exit tax" provision of the tax bill. I do believe that upholding the rule of law is important, and I also believe that this provision raises a sufficiently serious question under International Law that it warrants careful consideration before making a final decision on Section 201. To that end, Madam Chairman, I commend you for scheduling this hearing.

Even if in the end you conclude that the provision does not, in reality, violate the Nation's solemn human rights obligations, if there is even a colorable claim to the contrary that might be raised to undermine future US efforts to enforce human rights laws, it might be wise to avoid even the appearance of violating these laws. In the end it may come down to balancing the importance of the tax code provision against the potential harm that might result if we are perceived as having violated these important rules of international human rights law.

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[1] *Inter alia*, this provision would amend the Internal Revenue Code by adding this language:

> If any United States citizen relinquishes his citizenship during a taxable year, all property held by such citizen at the time immediately before such relinquishment shall be treated as sold at such time for its fair market value and any gain or loss shall be taken into account for such taxable year.

That the "exit tax" is designed to affect a relatively small portion of the population is clear from the fact that the first $600,000 of gross income is excluded from this provision. According to the State Department, 697 US citizens expatriated in 1993 and 858 the following year. "It is not yet known how many of these former citizens, if any, will be subjected to tax under section 877." JOINT COMMITTEE ON TAXATION, DESCRIPTION OF REVENUE PROVISIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 1996 BUDGET PROPOSAL 17 n.6 (Feb. 17, 1995). The fact that the Treasury Department anticipates more than $2 billion in additional revenues from this provision by FY 2000 suggests either that many expatriates will be covered or that the few covered will be hit with rather substantial additional tax bills under this provision. *See infra*, note 68.

[2] Letter of invitation from the Honorable Nancy L. Johnson, Chairman, Subcommittee on Oversight, to Robert F. Turner, dated March 23, 1995.

[3] 19 U.S.C. §§ 2192 *et seq.*

The Growth of a Legal Right to Emigrate

Today the right of citizens to renounce their citizenship and leave their own country is almost universally recognized as a fundamental human right, but its widespread recognition as creating international obligations among States is of relatively recent origin. The origin of the right of **emigration** (i.e., the right to depart from one's country with the intention of not returning) and **expatriation** (i.e., the renunciation of one's citizenship) as a matter of internal law can arguably be traced back nearly 2500 years, as reflected in this excerpt from the famous *Dialogues of Plato*, in which Socrates says to Crito:

> [H]aving brought you into the world, and nurtured and educated you, and given you and every other citizen a share in every good which we had to give, we further proclaim to any Athenian by the liberty which we allow him, that if he does not like us when he has become of age and has seen the ways of the city, and made our acquaintance, he may go where he pleases and take his goods with him. None of . . . [our] laws will forbid him or interfere with him. Any one who does not like us and the city, and who wants to emigrate to a colony or to any other city, may go where he likes, retaining his property.[4]

The original 1215 version of the *Magna Carta* issued by King John at Runnymede guaranteed the right of "any one to go out from our kingdom, and to return, safely and securely, by land and by water, saving their fidelity to us"; but even this limited "right to travel" was omitted from the forty-six subsequent versions—including the one issued by Henry III in 1225 usually associated with the term "Magna Carta"—on the grounds that such a right seemed "weighty and doubtful."[5] Nor, for that matter, did the right to "travel" included a right of expatriation—a right far more easily sustained in the modern era, now that people have changed from being "subjects" of the King to being "citizens" of the State.

The Alleged Distinction Between "Emigration" and "Expatriation"

MADAM CHAIRMAN, the Office of the Legal Adviser to the Department of State,[6] the Congressional Research Service of the Library of Congress,[7] and some of my colleagues in the international law teaching community are trying to distinguish the right to "travel" from the act of renouncing one's citizenship. Apparently underlying this view is the assumption that there is no legal "right" of expatriation—that is to say, no right to renounce one's allegiance to one's native country.

This argument was perhaps first set forward by my good friend and respected University of Virginia colleague, Professor Paul Stephan, in a letter to Assistant Secretary of the Treasury Leslie B. Samuels, in which he wrote:

> [I]t is critical to recognize the distinction between the right to travel, on the one hand, and the right to change one's citizenship status, on the other. Emigration necessarily involves the former, but not necessarily the latter. The human rights concerns that dominated our encounters with the Soviet Union and other totalitarian regimes during the 1970s and 1980s were based on violations of the right to travel. . . . The so-called education tax that the Soviet Union threatened to impose on emigrants, which inspired the . . . Jackson-Vanik Amendment, was triggered by a request to travel abroad, not by an attempt to renounce Soviet citizenship. Whether the communist regimes also made it difficult to surrender citizenship was a matter of indifference to us. . . .
>
> The Administration's proposal . . . has absolutely no effect on the right of a citizen to travel abroad. It is triggered only by a change of citizenship status, not by the crossing of the country's borders. . . .

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[4] THE DIALOGUES OF PLATO 217 (7 Britanica Great Books of the Western World, 1952). *See also*, Jeffrey Barist *et al.*, *Who May Leave*, 15 HOFSTRA L. REV. 381, 384 (1987).

[5] By coincidence, I discussed this issue in my prepared testimony before the Senate Judiciary Committee Subcommittee on the Constitution on 5 October 1994 (page 2-3 of original text), which has not yet, to my knowledge, been published.

[6] *See* "Prepared Statement of Jamison S. Borck, Deputy Legal Adviser, U.S. Department of State, Before the Senate Committee on Finance, March 21, 1995."

[7] Congressional Research Service, American Law Division, Memorandum on "Whether Legislation That Would Tax Property Upon Expatriation Constitutes a Violation of International Law," March 28, 1995 (hereinafter cited as "CRS").

> In summary, the international law of human rights is concerned with restrictions on the right to leave one's country, not those on the right to renounce one's citizenship. . . . For these reasons, it is inconceivable to me that the Administration's proposal could be seen as violating international human rights law.[8]

With all due respect to my good and highly respected friend Paul, who joins me on this panel and thus will be able to explain his position in greater detail, I believe he is mistaken on three important points:

- To be sure, the Jackson-Vanik Amendment used the term "emigration"; but I followed that issue closely as a Senate staff member in 1974—at a time when my younger colleague was just entering law school—and I am quite confident that our "concern" involved *all* of the impediments imposed by the Soviet Union to impede the permanent departure of Soviet citizens to other countries and their complete severance of the citizen-State relationship.

- Secondly, I believe Paul is mistaken when he asserts that International Law is not "concerned" with the "right to renounce one's citizenship."

- Finally, and I venture this point with less confidence in deference to Paul's greater expertise in Soviet Law, my understanding is that an important component of the Soviet effort to prevent Soviet Jews from emigrating to (and becoming citizens of) Israel was a 500-ruble "citizenship renunciation fee" that few could afford.

I will address each of these points in greater detail in the statement which follows.

The United States and the "Natural Right" of Expatriation

It is important to keep in mind that the claimed "right of expatriation" was at the very *core* of the intellectual justification for the American Revolution and has long been a fundament of US policy.[9] The very first sentence of the Declaration of Independence asserted that "the laws of nature" (which the Declaration's authors believed was a primary basis of International Law[10]) entitled "one people to dissolve the political bands which have connected them with another"[11] by declaring their independence. I hesitate to contemplate the potential consequences if the view voiced by the State Department last week had been shared by our Founding Fathers. But it clearly was not, and even before the Declaration of Independence was written, the great Virginia jurist St. George Tucker noted that Virginia courts had rejected the feudal doctrine of "indefeasible allegiance"—often expressed as "once an Englishman, always an Englishman"—and had recognized a "right of expatriation."[12]

MADAM CHAIRMAN, while I am not appearing here on behalf of the University of Virginia, it is difficult to be associated with that great institution without being impressed by the transcendental wisdom of its founder, Thomas Jefferson. And, as is true with so many subjects, his legacy of brilliant writings provides insight directly relevant to this issue.

As early as 1774, in his *A Summary View of the Rights of British Americans*, Jefferson reminded King George II that:

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[8] Letter from Professor Paul B. Stephan III to Leslie B. Samuels, Assistant Secretary of the Treasury for Tax Policy, dated March 20, 1995, submitted for the record during the Senate Finance Committee hearing on this issue.

[9] "Founded as it was on emigration from other countries, the United States has long taken the position that the right to alter one's status by expatriation is an 'inherent and fundamental right.'" Seth F. Kreimer, *"But Whoever Treasures Freedom . . .*", 91 MICH. L. REV. 9-7, 938 n.73, *quoting* JAMES H. KETTNER, THE DEVELOPMENT OF AMERICAN CITIZENSHIP 1608-1870 at 267-70 (1978).

[10] It should be kept in mind that Jefferson believed that a primary basis of International Law (then called "the Law of Nations") was "natural law." To that end, his extensive collection of treatises in this area was catalogued under the heading "Law of Nature and Nations." *See, e.g.*, 2 CATALOGUE OF THE LIBRARY OF THOMAS JEFFERSON 67-88 (1983). *See infra*, note 14 and accompanying text.

[11] "When in the course of human events it becomes necessary for one people to dissolve the political bands which have connected them with another, and to assume among the powers of the earth the separate and equal station to which the laws of nature & of nature's god entitle them, a decent respect for the opinions of mankind requires that they should declare the causes which impel them to the separation." DECLARATION OF INDEPENDENCE. *See, generally*, JAMES MUNVES, THOMAS JEFFERSON AND THE DECLARATION OF INDEPENDENCE: THE WRITING AND EDITING OF THE DOCUMENT THAT MARKED THE BIRTH OF THE UNITED STATES OF AMERICA (1978).

[12] Craig Evan Klafter, *The Influence of Vocational Law Schools on the Origins of American Legal Thought, 1779-1829*, 37 AM. J. LEGAL HIST. 307, 320 (1993).

> [O]ur ancestors, before their emigration to America, were the free inhabitants of the British dominions in Europe, and possessed a right, which nature has given to all men, of departing from the country in which chance, not choice, has placed them, of going in quest of new habitations, and of there establishing new societies, under such laws and regulations as, to them, shall seem most likely to promote public happiness.

Jefferson noted that:

> Their Saxon ancestors had, under this universal law, in like manner, left their native wilds and woods in the North of Europe, had possessed themselves of the Island of Britain, then less charged with inhabitants, and had established there that system of laws which has so long been the glory and protection of that country. Nor was ever any claim of superiority or dependence asserted over them by that mother country from which they had migrated; and were such a claim made, it is believed his Majesty's subjects in Great Britain have too firm a feeling of the rights derived to them from their ancestors, to bow down the sovereignty of their State before such visionary pretensions.

Thus, Jefferson was clearly asserting a "natural right" not only to depart from one's native country (to emigrate) but also to sever the legal relationship which creates legal duties and rights between citizens and their native State. It is perhaps worth noting that Jefferson's thesis drew support in 1791, when the French Declaration of the Rights of Man affirmed the right "to come and to go" from the State as a "natural" right.[13]

The proposal before you comes from the Department of the Treasury; and thus, it may be useful to recall Jefferson's June 1806 letter to Secretary of the Treasury Albert Gallatin—the individual who occupied that post longer than any person in history, and whose statue stands outside its walls—in which our third president wrote:

> I hold the right of expatriation to be inherent in every man by the laws of nature, and incapable of being rightfully taken from him even by the united will of every other person in the nation. If the laws have provided no particular mode by which the right of expatriation may be exercised, the individual may do it by any effectual and unequivocal act or declaration.

Addressing the power of the US Congress to interfere with this right to renounce one's citizenship, Jefferson added:

> Congress may, by the Constitution, "establish an uniform rule of naturalization", that is, by what rule an alien may become a citizen; but they cannot take from a citizen his natural right of divesting himself of the character of a citizen by expatriation.

Jefferson addressed this issue again in his 1821 *Autobiography*, when in discussing his own theory of American independence he argued that "our emigration from England to this country gave her no more rights over us, than the emigrations of the Danes and Saxons gave to the present authorities of the mother country, over England." He reasoned that "expatriation being a natural right, and acted on as such, by all nations, in all ages," the colonists were legally free to dissolve their relationship with Great Britain.

Make no mistake about it—Jefferson was espousing what he viewed to be principles of International Law. In his view, "[t]he law of nations . . . [was] composed of three branches. 1. The moral law of our nature [or 'natural law']. 2. The usages of nations [what we today call 'customary law']. 3. Their special conventions [e.g., 'treaties' or 'positive' law]."[14]

In Jefferson's clearly expressed view, both the law of "nature" and the law of nations denied the United States Government the legal right to deny this fundamental "right of expatriation" to its citizens. It saddens me to witness able attorneys—on behalf of the Department of State, which Thomas Jefferson personally set up as our first Secretary of State—suggest that the right to "travel" is not accompanied by a clear human right to renounce U.S. citizenship. Having served in

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[13] *Id.* at 4, and Barist *et al.*, *Who May Leave*, 15 HOFSTRA L. REV. at 384.

[14] 3 WRITINGS OF THOMAS JEFFERSON 228 (Mem. ed. 1904). Today, the International Court of Justice views as "sources" of international law "international conventions," "international custom," the "general principles of law recognized by civilized nations," and "judicial decisions and the teachings of the most highly qualified publicists of the various nations [as subsidiary means]." I.C.J. STATUTE, Art. 38.

the Department of State myself.[15] I understand the loyalty Executive branch employees often feel to defend the President's position. But in this case I doubt seriously that the President was even aware that a human rights issue existed when this tax was proposed and approved.

Nor was Jefferson alone in upholding the right of Americans to renounce their previous citizenship. Secretaries of State John Marshall, James Madison, and James Monroe embraced the same doctrine; and through the early naturalization laws Congress, too, implicitly endorsed the view by requiring new citizens to renounce prior allegiances to former States before becoming Americans.[16] Furthermore, the War of 1812 was fought in no small part for the principle that Great Britain lacked any legal authority over former British citizens who had renounced that relationship while accepting naturalized U.S. citizenship.

In 1859, Attorney General Black wrote:

> The natural right of every free person, who owes no debts and is not guilty of any crime, to leave the country of his birth in good faith and for an honest purpose, the privilege of throwing off his natural allegiance and substituting another allegiance in its place—the general right, in one word, of expatriation, is incontestable. . . . We take it from natural reason and justice, from writers or known wisdom, and from the practice of civilized nations. All these are opposed to the doctrine of perpetual allegiance.[17]

The view that there is a fundamental right of citizens to renounce their allegiance to one State and move to live elsewhere without punishment was embraced by the US Congress in 1868—during another of many controversies with Great Britain concerning the rights of naturalized U.S. citizens—by enactment of "An Act Concerning the Rights of American Citizens in Foreign States," which provided in part:

> Whereas *the right of expatriation is a natural and inherent right of all people, indispensable to the enjoyment of the rights of life, liberty, and the pursuit of happiness*; and whereas, in the recognition of this principle this government has freely received emigrants from all nations, and invested them with the rights of citizenship; and whereas it is claimed that such American citizens, with their descendants, are subjects of foreign states, owing allegiance to the governments thereof; and whereas it is necessary to the maintenance of public peace that this claim of foreign allegiance should be promptly and finally disavowed: Therefore, any declaration, instruction, opinion, order, or decision of any officers of this government which denies, *restricts, impairs*, or questions *the right of expatriation, is declared inconsistent with the fundamental principles of this government.*[18]

Finally, two years later, Great Britain abandoned its claim of "once an Englishman, always an Englishman," and enacted a statute which provided that British citizens who became naturalized in other countries would become aliens under British law.[19]

In 1894, Secretary of State Gresham refused to issue a certificate to assure the Russian Government that the United States had no objections to the granting of Russian citizenship to an American citizen, on the grounds that such a document might undermine the important principle that—and here he quoted the 1868 statute—the "right of expatriation is a natural and inherent right of all people."[20] In the American view, such documents were unnecessary and inappropriate.

More recently, Section 349(a) of the Immigration and Nationality Act recognizes a right of every citizen to relinquish US citizenship.[21] Just a decade ago, the US Court of Appeals for the Ninth Circuit observed that "expatriation has long been recognized as a *right* of United States citizens," and noted that "the Supreme Court [has] placed the right of voluntary expatriation solidly on a constitutional footing."[22]

The proposed "exit tax," of course, does not expressly challenge this well-established right to emigrate/expatriate—it merely provides that a few dozen very wealthy citizens will be forced to pay a major tax on unrecognized appreciation of assets should they wish to exercise this

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[15] I served as Principal Deputy Assistant Secretary of State for Legislative and Intergovernmental Affairs, and for several months as Acting Assistant Secretary, during the Reagan Administration.

[16] *See, e.g.*, Alan G. James, *Expatriation in the United States: Precept and Practice Today and Yesterday*, 27 SAN DIEGO L. REV. 853 (1990).

[17] *Quoted in id.*

[18] Expatriation Act of 1868, 15 Stat. 223 (1868) (emphasis added).

[19] James, *supra* note 16.

[20] *Id.*

[21] 8 U.S.C. § 1481, *quoted in* 87 AM. J. INT'L L. 601 (1993).

[22] *Richards v. Secretary of State*, 752 F.2d 1413 at 1422 (1985).

constitutional and international human right. In one sense the proposal does not "tax" the decision to exercise the well-established right—it simply provides as a matter of law that the Government will *pretend* that anyone exercising that right (who, in the subjective judgment of the Internal Revenue Service, is thought to be motivated by a desire to avoid additional tax liability) has sold all of his or her property. In reality, there would be no factual issue as to whether the targets of this tax had actually sold the property in question. This tax would only apply to property that had *not* been sold. But the Treasury Department has figured out that if we can just pretend that they did sell it, while perhaps we can't actually keep them from leaving and renouncing their American citizenship, we can at least make sure that they leave behind another $40 million or so each to help us offset the deficit. All in all, Treasury estimates that the two dozen or so U.S. citizens who are likely candidates for this proposed tax will bring in something in excess of $1 billion toward deficit reduction. And since these individuals will lose their right to vote simultaneously with incurring the tax obligation, I can certainly understand how this might be an attractive proposition to those of you who must come up with solutions to the deficit problem.

International Law and Constraints on the Right to Emigrate/Expatriate

MADAM CHAIRMAN, the issue you have invited me to address, I gather, is whether such a tax would bring the United States into noncompliance with any binding rules of International Law. As I indicated at the start, I am not sufficiently versed on issues of tax law to answer that question with complete confidence; but perhaps I can be of assistance by at least summarizing the existing international law binding upon the United States concerning the human right to emigrate/expatriate.

Let me began by briefly setting forth the status of the right to emigrate under International Law. I will first consider the relevant conventional (treaty) law binding upon the United States, followed by a look at some "non-binding" international documents which may shed light on these issues, and finally I will discuss the very important area of customary international law (which, under the Statute of the International Court of Justice, is considered as equal in authority to conventional law[23]).

Conventional International Law

The effort to codify international human rights law is of quite recent origin, essentially coming in the wake of World War II and the establishment of the United Nations. Article 55 of the UN Charter establishes as a goal the promotion of "universal respect for, and observance of, human rights and fundamental freedoms for all without distinction as to race, sex, language, or religion." In Article 56, "All Members pledge[d] themselves to take joint and separate action in co-operation with the Organization for the achievement of the purposes set forth in Article 55."

An important first step was the unanimous adoption (with eight abstentions, including the Soviet Union and several other Communist States) on 10 November 1948 of the "Universal Declaration of Human Rights," which will be discussed below under Customary International Law.

The International Covenant on Civil and Political Rights

In an effort to follow up the Declaration with a series of binding treaties, in 1966 the United Nations General Assembly unanimously approved the International Covenant on Civil and Political Rights, which entered into force on 23 March 1976. The following year, it was signed by the Carter Administration and on 23 February 1978, it was submitted to the Senate for its advice and consent.

In 1991, President Bush asked the Senate to consider the treaty, and hearings were held late that year in the Foreign Relations Committee, which recommended approval of the treaty by a unanimous (19-0) vote. On 2 April 1992, the Senate consented to the ratification of the treaty with a variety of proposed reservations, understandings, and declarations[24]; and the instrument of ratification was deposited with the United Nations on 8 June of that year with the recommended

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[23] STATUTE OF THE INTERNATIONAL COURT OF JUSTICE, Art. 38. While customary law may over time replace a rule established by treaty, and the general goal is to ascertain the most recent expression of the consent of the parties (thus a more recent customary practice accepted as law [*opinio juris*] may prevail over a prior treaty), it is probably accurate to observe that, where a relevant treaty exists between the parties to a dispute, the terms of the treaty will provide at least the starting point for resolution of the dispute. However, the principle that "the specific prevails over the general" (*lex specialis derogat generali*) may well lead to a narrow customary practice prevailing over a more general treaty obligation.

[24] REPORT OF THE SENATE COMMITTEE ON FOREIGN RELATIONS ON THE INTERNATIONAL COVENANT ON CIVIL AND POLITICAL RIGHTS, *reprinted in* 31 INT'L LEG. MATS. 645 (1992).

additions—none of which apply directly to the issue at hand.[25] The United States thus joined more than 100 other States in assuming a solemn international legal obligation to abide by the terms of the Covenant.

It is perhaps worth noting that the unanimous report of the Foreign Relations Committee on this treaty categorized the "rights enumerated in the Covenant" as being "the cornerstones of a democratic society."[26] By its own terms, the Covenant was designed to be a legally-binding international treaty setting forth "inalienable rights" which were said to be "derive[d] from the inherent dignity of the human person"[27]—which sounds an awful lot like Jefferson's "natural law" rationale. Article 12 of the Covenant provides:

> ***Article 12***
>
> 1. Everyone lawfully within the territory of a State shall, within that territory, have the right to liberty of movement and freedom to choose his residence.
> 2. Everyone shall be free to leave any country, including his own.
> 3. **The above mentioned rights shall not be subject to any restrictions except those which are provided by law, are necessary to protect national security, public order (*ordre public*), public health or morals or the rights and freedoms of others,** and are consistent with the other rights recognized in the present Covenant.
> 4. No one shall be arbitrarily deprived of the right to enter his own country.[28]

The American Society of International Law commissioned an excellent study of *The Movement of Persons Across Borders*, edited by two of the nation's foremost scholars in this area (Professors Louis B. Sohn and Thomas Buergenthal), which provides important background on the interpretation of the Article 12 of the Covenant. Among other things, the authors note that one of the reasons Article 12 was written was that, "[n]otwithstanding Article 13(2) of the . . . [Declaration], some countries prevent their nationals from leaving, prescribe *unreasonable conditions such as exacting taxes or confiscating property* . . . . [emphasis added]"[29]

While Article 12 embodies a "fundamental right," it is not an "absolute right" in the sense that a State may not legitimately place some reasonable restrictions by law on the right of emigration. In addition to preventing individuals accused of serious crimes from leaving,[30] for example, it is clear that a State may require a citizen to pay any normal tax obligations or other public debts.[31] However, people who wish to emigrate may not lawfully be required to surrender their "personal property," and "Property or the proceeds thereof which cannot be taken out of the country shall remain vested in the departing owner, who shall be free to dispose of such property or proceeds within the country."[32] It seems to me that a key issue with respect to the proposed US "exit tax" is whether or not it represents a normal tax obligation applicable to all citizens irrespective of their wish to emigrate. To the extent that it constitutes a special requirement on individuals because of their desire to emigrate, then the Government would presumably have the burden under the Covenant of establishing that the law is "necessary to protect national security, public order (*ordre public*), public health or morals or the rights and freedoms of others . . . ."[33]

In this regard I noted that the Congressional Research Service legal memorandum on this issue suggests that the term "public order" is "roughly analogous to the concept of public policy and likely includ[es] such notions as 'economic order.'"[34] While I'm not prepared to say that such an interpretation is beyond the pale, it may be relevant that efforts were made during the drafting of Article 12 to broaden this list of permissible exceptions to include such concepts as promoting a State's "general welfare" and "economic and social well-being"—either of which might have arguably justified a special tax provision targeting unrealized appreciation of assets (and perhaps also a tax on the value of a State-funded Soviet education)—but these were *rejected* as

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[25] A possible exception is the first Declaration, specifying that the Covenant is Non-Self-Executing. *Id.* at 651.
[26] REPORT OF THE SENATE COMMITTEE ON FOREIGN RELATIONS ON THE INTERNATIONAL COVENANT ON CIVIL AND POLITICAL RIGHTS, *supra* at 649 (p. 3 of OT).
[27] Preamble, 6 INT'L LEG. MATS. 368 (1967).
[28] Art. 12, *id.* at 372 (**Bold** emphasis added.).
[29] THE MOVEMENT OF PERSONS ACROSS BORDERS 76 (Louis B. Sohn & Thomas Buergenthal, eds. 1992).
[30] *Id.* at 79.
[31] *Id.* at 82.
[32] *Id.* at 81, quoting Article 6 of the 1989 Strasbourg Declaration on the Right to Leave and Return (prepared by a group of international experts under the auspices of the International Institute of Human Rights).
[33] International Covenant on Civil and Political Rights, Art. 12.
[34] CRS, *supra* note 7, at CRS-2.

being "too far-reaching."[35] Restrictions on freedom of movement were only to be permitted in "exceptional" circumstances.[36]

I would note in this regard that, to the extent the precise meaning of Article 12 is "ambiguous or obscure," the Vienna Convention on the Law of Treaties[37]—which, although not ratified by the United States, is viewed by our Government as codifying existing customary international law in this respect[38]—permits recourse to "preparatory works" (*travaux préparatoire*).[39] The clear *rejection* of exceptions based upon a State's "general welfare" or "economic . . . well being" would seem to pose a serious obstacle to interpreting the Covenant to permit such an "exit tax" (or, if you prefer the term used by the Congressional Research Service experts, an "expatriation tax"[40]).

Furthermore, Professor Louis Henkin, of Columbia Law School, has noted that:

> The Covenant . . . is not to be read like a technical commercial instrument, but "as an instrument of constitutional dimension which elevates the protection of the individual to a fundamental principle of international public policy." Rights are to be read broadly, and limitations on rights should be read narrowly, to accord with that design.[41]

This view is widely shared by other experts in the field.[42] Discussing Article 12 in a lengthy 1987 article in the *Hofstra Law Review*, a group of four attorneys from the New York law firm of White & Case concluded:

> Although it is accepted that there may be restrictions imposed on the right to emigrate, these restrictions are of an exceptional character and must be strictly and narrowly construed. The right to emigrate is primary; the restrictions on that right are subordinate and may not be so construed as to destroy the right itself.[43]

For the record, the United States is now also a party to the International Convention on the Elimination of All Forms of Racial Discrimination, which prohibits barring freedom of movement (and many other enumerated rights) on the basis of "race, colour, or national or ethnic origin"[44]—however, this treaty does not appear to be relevant to the issue at hand. There are several other international conventions which guarantee the right to emigrate, including regional agreements underlying the European, African, and Inter-American human rights systems. However, the United States is not a Party to these, so in the interest of time I have not addressed their specifics. (While they do serve as evidence of customary legal obligations, in this area the statutory language of the Jackson-Vanik Amendment [discussed *infra*] assures that the United States is bound by the highest standards of customary law in this area.)

Other International Instruments of Relevance

As already noted, the Universal Declaration of Human Rights was intended to be aspirational and not legally binding upon the 48 States that voted to approve it. Because it reflects customary law, it will be discussed under that heading—but it also stands as an important non-treaty human rights document.

Another very important international document clearly not intended to create binding legal rights was the Final Act of the Conference on Security and Cooperation in Europe (Helsinki Accords), which expressly incorporated the Declaration.[45] Time has precluded me from addressing these types of instruments further, but they are probably not critical to a resolution of the issue.

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[35] Barist *et al.*, *Who May Leave*, 15 HOFSTRA L. REV. at 389.

[36] *Id.* at 389, 394.

[37] U.N. Doc. A/CONF. 39/27 (1969), *reprinted in* 8 INT'L LEGAL MATS 679 (1969).

[38] In submitting the convention to the Senate for its advice and consent to ratification, the Department of State asserted that it is "already recognized as the authoritative guide to current treaty law and practice." S. EXEC. DOC. L., 92nd Cong, 1st Sess. at 1 (1971).

[39] Arts. 31 & 32.

[40] CRS, supra note 7, at CRS-5.

[41] THE INTERNATIONAL BILL OF RIGHTS: THE COVENANT ON CIVIL AND POLITICAL RIGHTS 24 (Louis Henkin, ed. 1981), *quoted in* Barist *et al.*, *Who May Leave*, 15 HOFSTRA L. REV. at 395.

[42] Barist *et al.*, *Who May Leave*, 15 HOFSTRA L. REV. at 396.

[43] *Id.* at 406.

[44] 660 U.N.T.S. 194.

[45] 14 INT'L LEG. MATS. 1292 (1975).

Customary International Law

Perhaps the most important written source of customary international human rights law[46] is the Universal Declaration of Human Rights, approved on 10 November 1948 as a UN General Assembly Resolution. Such resolutions do not have legal effect,[47] and the Declaration was clearly viewed as aspirational at the time—indeed, Mrs. Franklin D. Roosevelt, speaking on behalf of the United States delegation, expressly stated:

> In giving our approval to the declaration today, it is of primary importance that we keep clearly in mind the basic character of the document. It is not a treaty; it is not an international agreement. It is not and does not purport to be a statement of law or of legal obligation. It is a declaration of basic principles of human rights and freedoms, to be stamped with the approval of the General Assembly by formal vote of its members, and to serve as a common standard of achievement for all peoples of all nations.[48]

However, there is a *very* strong consensus today that the *Declaration* is legally binding by virtue of reflecting customary international law.[49] It provides:

> **Article 13**
>
> 1. Everyone has the right to freedom of movement and residence within the borders of each State.
> 2. Everyone has the right to leave any country, including his own, and to return to his country.[50]

In view of the current attempt by supporters of the proposed new tax to distinguish the right of "emigration" from the act of renouncing citizenship, it should be noted that the Declaration also provides:

> **Article 15**
>
> 1. Everyone has the right to a nationality.
> 2. *No one shall be* arbitrarily deprived of his nationality nor *denied the right to change his nationality.*[51]

During the debate on the Jackson-Vanik Amendment in 1974 (discussed *infra*), this document was occasionally portrayed as an international treaty designed to create legal rights.[52] In reality, its only "legal" value is as evidence of binding customary law—but as such it is quite powerful. Its status as evidence of customary law may be important background for the discussion which follows, because the Soviet Union voted against Article 13 during the drafting process and did not vote in favor of the *Declaration* itself in the General Assembly. With a few exceptions, which are not relevant to the issue at hand,[53] rules of International Law are established by the *consent* of States. This can be done explicitly by ratifying a treaty or other international agreement,

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[46] To constitute binding international customary law, a rule must reflect "a general practice" that has been "accepted as law" (*opinio juris*). *See* STATUTE OF THE INTERNATIONAL COURT OF JUSTICE, Art. 38 (1) (b).

[47] However, a UNGA resolution expressing legal principles approved by an overwhelming vote of Member States may serve as powerful evidence of the existence of a legally-binding international custom.

[48] 19 DEP'T STATE BULL. 751 (1948).

[49] *See, e.g.,* RICHARD B. LILLICH & FRANK C. NEWMAN, INTERNATIONAL HUMAN RIGHTS: PROBLEMS OF LAW AND POLICY 7 (1979); LOUIS SOHN & THOMAS BUERGENTHAL, INTERNATIONAL PROTECTION OF HUMAN RIGHTS 518-19 (1973); and Humphrey, *The UN Charter and the Universal Declaration of Human Rights*, in THE INTERNATIONAL PROTECTION OF HUMAN RIGHTS 51 (Luard, ed., 1951).

[50] UNGA Res. 217 A (III), 3 UNGAOR 71, UN Doc. A/810 (10 Nov. 1948).

[51] *Id* (emphasis added).

[52] *See, e.g.,* 120 CONG. REC. 39787 (1973) (referring to the "ratifying nations" of the Declaration).

[53] Some rules of International Law are of such fundamental importance that they are considered "peremptory norms" (*jus cogens*) and bind all States irrespective of consent. A thorough discussion of this issue is precluded by the short time available to prepare this testimony. Some human rights principles have this status—it is doubtful that this is one of them. The issue is of only academic interest given the strong statement of the right to emigrate as constituting binding International Law contained in the Jackson-Vanik Amendment to the 1974 Trade Act (discussed below). Thus, the United States could hardly protest that it is not bound by this rule and claim to have protested against its creation.

or it may be done implicitly by taking part in the development of a consistent and general practice accepted as law. But—again, with some exceptions[54]—a State is not considered bound by customary legal rules against which it clearly protested during formation. Thus, it is at least arguable[55] that the Soviet Union was not bound by the Declaration as customary law in 1974.

The United States, in contrast, played a leading role in the drafting of the Declaration and has frequently treated its provisions as reflective of customary international law. In addition to the Jackson-Vanik Amendment, I would note that on 9 November 1982 the Department of State expressly invoked the Declaration in denouncing Romania's "public education tax."[56]

The 1974 Jackson-Vanik Amendment

MADAM CHAIRMAN, it is important to keep in mind that the United States Congress played a prominent role in the affirmation of customary international law governing the right of citizens to emigrate without having to pay burdensome special taxes. I don't know how many current members of the subcommittee served in the Ninety-Third Congress, so it may be useful for me to review the history of the "Jackson-Vanik" Amendment—also know as the "Freedom of Emigration" Amendment[57]—briefly at this time. I remember it reasonably clearly, for, as I mentioned, I was serving at the time on the staff of Senator Bob Griffin and I followed the Amendment closely.

The genesis of the Amendment was the effort by the Soviet Union to restrict Jewish emigration to Israel. In 1972, Moscow announced that future emigrants who had received higher education at the State's expense would have to pay a "diploma tax" to compensate for the value of the skill they were taking out of the country. In addition, at least as reported in the *New York Times* at the time, Soviet citizens wishing to emigrate to countries that lacked diplomatic relations with the USSR had to pay an additional 500-ruble "citizenship renunciation fee."[58]

As I said earlier, I am most hesitant to get into a quarrel with my good friend Paul Stephan about the details of Soviet law, as he is far more knowledgeable than I am on that general subject. However, I did take the liberty to look up "Emigration" in the two-volume 1973 *Encyclopedia of Soviet Law*, and I found an entry which read in part:

> [T]he current exodus of Jews from the USSR to Israel has led to the adoption of new restrictive administrative practices calculated to curb the flow of departures, intimidate potential applicants for exit permits, or bar the emigration of certain individuals whose qualifications are considered too valuable by the authorities to risk losing their services. These measures have included . . . *adherence to the requirement that the petitioner first formally relinquish his Soviet citizenship and pay a 500-rouble fee for the privilege of so doing*, [and] the imposition of an exorbitant surtax on those seeking an emigration visa justified as indemnification owed to the state for the cost of their education and professional training . . . .[59]

If Paul believes that these reports were in error, he may well be right for all I know and I would urge you to consider his evidence carefully. However, the fact remains that these were the kinds of reports we were getting on the Hill at the time; and even if they were mistaken they certainly influenced our thinking. Thus, when Paul writes that "we"—and here I assume the antecedent is the supporters of the Jackson-Vanik Amendment in the Legislative branch—were "indifferen[t]" to "[w]hether the communist regimes also made it difficult to surrender citizenship," he is simply mistaken.[60]

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[54] *Jus cogens* rules (discussed *supra*) bind all States, and newly-formed States are bound by all rules of customary law in existence when they are created.

[55] In reality, a strong case can be made that the Soviet Union was bound by this provision of the Declaration in 1974. Among other things, abstention in the General Assembly does not constitute an adequate "protest" to protect against being bound (although it does not constitute "consent" either). The following year the issue was arguably resolved when Moscow signed the Helsinki Accords (which, as discussed *supra*, incorporated the text of the *Declaration*.) While the Helsinki Accords were not designed to be legally binding in themselves, Moscow's acceptance of the principles of the *Declaration* would seem to undercut any Soviet claim that it objected to these principles as *customary* law.

[56] *See*, Statement of State Department Press Spokesman John Hughes, 9 Nov. 1982.

[57] *See, e.g.*, Senate Report No. 93-1298 (Committee on Finance), *reprinted in* 4 U.S. CODE CONGRESSIONAL & ADMIN. NEWS 7338 (93d Cong., 2d Sess., 1974) (hereinafter cited as FINANCE COMMITTEE REPORT).

[58] *See, e.g.*, Gregory I. Teitelbaum, *Not This Year in Jerusalem*, NEW YORK TIMES, 9 February 1973, p. 35.

[59] 1 ENCYCLOPEDIA OF SOVIET LAW 245 (F.J.M. Feldbrugge, ed. 1973) (emphasis added).

[60] States may impose a wide range of substantial burdens on their citizens who reside abroad, ranging from various types of taxes to a requirement that they return to their homeland upon demand for military service, to appear in judicial proceedings, and the like. The clear objective of the Jackson-Vanik Amendment was not merely that Moscow allow Soviet Jews (and others) to make occasional tourist excursions to Israel (or elsewhere), but that these

As reported out of the House, Section 402 of the Trade Act of 1974 (H.R. 10710) included the so-called "Vanik Amendment"[61] which prohibited the President from granting "nondiscriminatory tariff treatment" to any "non-market economy country" which "imposes more than a nominal tax, levy, fine, fee or other charge on any citizen as a consequence of the desire of such citizen to emigrate to the country of his choice."[62] In its accompanying report, this Committee referred to the "right to emigrate" as a "basic human right . . . ."[63]

When the trade bill reached the Senate floor in mid-December 1974, this provision was strengthened by the enactment of the famous "Jackson Amendment" (with the final language affirming the right of emigration thus widely referred to as the "Jackson-Vanik Amendment"). Although strongly opposed by the Ford Administration as an impediment to *détente* with the Soviet Union, the Jackson Amendment was introduced in the Senate with 78 co-sponsors[64] and was approved unanimously.[65]

As enacted into law, the provision provided in part:

> **§ 2432. Freedom of emigration in East-West trade**
>
> . . . .
>
> (a) To assure the continued dedication of the United States to fundamental human rights, and notwithstanding any other provision of law, on or after . . . January 3, 1995, products from any nonmarket economy country shall not be eligible to receive nondiscriminatory treatment (most-favored-nation treatment), such country shall not participate in any program of the Government of the United States which extends credits or credit guarantees or investment guarantees, directly, or indirectly, and the President of the United States shall not conclude any commercial agreement with any such country, during the period beginning with the date on which the President determines that such country—
>
> (1) denies its citizens the right or opportunity to emigrate;
>
> (2) *imposes more than a nominal tax on emigration* or on the visas or other documents required for emigration, *for any purpose or cause whatsoever*; or
>
> (3) *imposes more than a nominal tax, levy, fine, fee, or other charge on any citizen as a consequence of the desire of such citizen to emigrate to the country of his choice*,
>
> and ending on the date on which the President determines that such country is no longer in violation of paragraph (1), (2), or (3).[66]

MADAM CHAIRMAN, even if you conclude that the proposed exit tax is not in conflict with the terms of the Covenant on Civil and Political Rights and the Universal Declaration of Human Rights, it strikes me that—given in particular the strong message sent by Congress via the Jackson-Vanik Amendment—it would be wise to consider whether this proposal complies with that standard as well.

Reconciling the Proposed US "Exit Tax" with Jackson-Vanik

Subjectively, of course, all of us can presumably agree that there is a substantial difference in the motivation behind the proposed US "exit tax" and the impediments placed in the path of Soviet Jews (and others) in the early 1970s designed clearly to discourage emigration (especially by dissident Jews to Israel). The United States understandably does not wish to lose the substantial sums in tax revenues which the Treasury Department projects could be lost if especially wealthy US citizens elect to renounce their citizenship and emigrate to foreign points—all the more so if the motivation for the move is perceived to be the avoidance of tax liability. Indeed, I think it is probably fair to assume that an underlying purpose for this proposal is to deter the so-called "super rich" from renouncing their citizenship; as, if they can be persuaded to maintain that relationship, we can probably extract even greater sums in tax revenues over the decades ahead.

While one might normally view this as a "political" problem for Congress to factor in during the drafting of the tax laws—how to extract maximum tax revenues from the wealthy without exceeding the point that the "geese that lay the golden eggs" will fly off to find a more

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Soviet citizens be permitted to depart permanently from the USSR and to sever all legal connections with that country.

[61] This amendment, introduced by Representative Charles Vanik, was approved on the House floor on 11 December 1974 by a vote of 319-80. *See* 120 CONG. REC. 39782 (1974).

[62] FINANCE COMMITTEE REPORT at 7213.

[63] *Id.* at 7338.

[64] 120 CONG. REC. 39782 (1974).

[65] *Id.* at 39806. The final vote was 88-0, with 12 Senators absent. All but two or three of the absent Senators were co-sponsors of the amendment.

[66] Trade Act of 1974, 19 U.S.C.A. § 2432 (emphasis added).

hospitable environment in which to do business[67]—there are obvious political attractions to the exit tax approach. Presumably few constituents will be directly affected by this legislation (and "soaking the rich" is not all that unpopular with many Americans of more ordinary means in these troubled times), and in order to be subject to the special "tax" an individual will have to renounce his or her American citizenship—in the process alienating more Americans and surrendering their right to vote in any case. One can see how this proposed new tax might have appeared to be a virtually cost-free (from a political standpoint) way to raise a couple of billion additional dollars over the next five or six years.[68]

From the standpoint of International Law, however, it may be more difficult to make the distinction between the old Soviet practice of charging a special "diploma tax" to compel citizens who wish to emigrate to compensate the State for its investment in their education, and the proposed US "exit tax" designed to compel citizens who wish to emigrate to compensate the State for income taxes they would likely eventually owe if they remained citizens. Both arguments are premised upon the idea that the citizen who wishes to abandon his country has received benefits of calculable value from a relationship with the State, and from which the State would likely benefit over the years if the relationship continued. Thus, if they wish to terminate the citizen-State relationship, it is only fair that they compensate the State for the value they have received through the efforts (or at least the indulgence) of the State.

Indeed, one might argue that the Soviet argument was the stronger one. There, the State *paid* the costs of education—turning ordinary people into doctors, engineers, scientists, and the like—with the expectation that the cost would be recouped over years of service to society. In contrast, presumably the targets of the Administration's proposed new tax gained their wealth by building better "mousetraps," investing wisely, or taking exceptional financial risks with their own resources—and perhaps getting "lucky." The State in this case did not "take them to raise," it simply sought to run a "fair gaming table" at which all citizens could seek their fortune. If a large casino in that circumstance sought to insist that "big winners" leave their profits behind when they left, many of us would think it unfair.

Under existing law, as I understand it, the Treasury Department (IRS) will have a legal right to a large chunk of these people's money *if* they eventually sell their property—but not before. However, the Treasury Department is in desperate need of additional money to help offset the deficit, and if these "super rich" citizens are allowed to walk away from the table and take their money to another "game" we probably won't be able to collect all of that money. So, they are asking you to pass a new law providing that, if certain particularly attractive targets have the audacity to "walk away from the game" by renouncing their US citizenship, we will simply *pretend* that they have at the same time sold all of their property. We can then hit them with multi-million dollar tax bills on the basis of these nonexistent "sales." Hopefully, this will deter most of them from leaving; but, even if some of them do get away, under this bill we can grab much of *their* wealth as they get on the boat to leave.

Obviously, everyone in this room will benefit if we can find another couple of billion dollars to apply toward deficit reduction. I'm not unaware of that, and, like most of you, I would like to see the deficit reduced. But, at the risk of sounding an unpopular note, it does strike me that there are some rather serious ethical and legal issues which need to be addressed.

Let me emphasize that it would *not* be illegal under these rules of International Law for the United States to tax unrealized capital gains annually, or for the Soviets to charge a fee for providing an education—the legal issue arises when people who seek to emigrate are treated less favorably than others because of their decision to exercise their legal right to emigrate. It strikes me that this proposal does that. I'm no tax expert, but it appears to me that, in at least some circumstances, changing markets might dramatically decrease the value of some of the assets in question by the time they were actually sold; and other appreciated assets might actually avoid capital gains taxation entirely through the demise of the owner.[69] But even if I am mistaken, and Treasury can tell us with certainty that every penny they wish to assess through this provision would eventually be due from these individuals over a period of time, I would suggest that *time* is in itself more than a "nominal" penalty.[70] While most of us presumably can't relate to the idea of

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[67] While I claim no special expertise on matters of finance or tax policy, I was impressed with *Forbes* magazine editor James W. Michaels' observation that "It's not that legislators sympathize with rich tax dodgers. It's that they realize it's time to worry less about soaking the rich and more about changing the tax code to make the country more hospitable to the capital that produces jobs and economic growth." James W. Michaels, "You can't take it (all) with you," FORBES, 13 March 1995, p. 10.

[68] The Treasury Department estimates that this provision will produce $2.2 billion in additional tax revenues between FY 1995 and FY 2000. DEPARTMENT OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S REVENUE PROPOSALS 17 (Feb. 1995).

[69] To be sure, they might then be subject to an inheritance tax.

[70] Does anyone believe the courts would enforce a statutory provision requiring that dissidents who burn the American flag must pay their income taxes earlier than other citizens?

owing tens of millions of dollars in income taxes, my point can be affirmed by simply asking how many Americans voluntarily pay their federal income taxes years before they are due?[71]

Congress Can By Statute Violate International Law

Perhaps I should make one additional point. The United States belongs to the *dualist* school and views municipal and international law as being separate, if often interrelated,[72] legal systems. United States courts will thus first attempt to reconcile the language of apparently inconsistent statutes and treaties, but if that proves unreasonable, they will apply the "later in time" doctrine (*lex posterior derogat priori*) and give legal effect to the instrument of most recent date.[73] The theory underlying this policy is that treaties and statutes have a co-equal standing as "supreme law of the land,"[74] and the lawmaking authority—be it the two chambers of the Legislative Branch acting with the approval (or over the veto) of the Executive,[75] or the Executive acting with the consent of two-thirds of those Senators present and voting[76]—is presumed to know the existing law when it acts and to intend the logical consequences of its actions. Thus, if the Congress enacts the provision in question and it is subsequently challenged as contrary to the nation's solemn treaty commitments, American courts will not strike down the statute because of the treaty. Similarly, while some scholars quarrel with the rationale,[77] the oft-cited 1900 Supreme Court case of *The Paquete Habana* held that "the customs and usages of civilized nations" (customary international law) is part of US law "*where there is* no treaty and *no controlling* executive or *legislative act* or judicial decision . . . ."[78] Furthermore, while the recently ratified Covenant clearly creates a solemn legal obligation upon the United States under International Law, it is not self-executing and thus will not be implemented by US courts in the absence of independent legislative authority.[79]

However, this is not to say that Congress has the legal power to relieve the United States from its solemn treaty obligations under International Law. On the contrary, no such right exists.[80] If the Congress elects to approve a statute that is contrary to the Covenant, it will by so doing make the United States an international lawbreaker.

To be sure, Congress in the past has on occasion enacted legislation which placed the Nation in such a status.[81] Such a decision has consequences, however. Not only might other treaty Parties have available meaningful remedies under International Law,[82] but violations of International Law by the United States contribute to a lack of respect for the rule of law in general and greatly undermine the ability of the United States to persuade other States to comply with such rules. Thus, in particular when the issue involves solemn undertakings in the area of international human rights, one would hope that legislators would be careful to avoid even the appearance of breaching provisions of a treaty.

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[71] On a somewhat lighter note, I believe it was Oscar Wilde who a century ago remarked: "Time is waste of money." Half-a-century later, George Bernard Shaw observed: "He who robs Peter to pay Paul can always depend on the support of Paul."

[72] As will be discussed, treaties are a part of the "supreme law of the land" and customary international law "is part of our law" too. The *monist* school views international law to be superior to municipal law in a single legal system.

[73] *See, e.g., Whitney v. Robertson*, 124 U.S. 190 (1888).

[74] US CONST. Art. VII

[75] *Id.* Art. I, Sec. 7.

[76] Id. Art. II, Sec. 2.

[77] *See, e.g.*, Louis Henkin, *The Constitution and United States Sovereignty*, 100 HARV. L. REV. 853 (1987).

[78] 175 U.S. 677 (1900) (emphasis added).

[79] For a discussion by Chief Justice Marshall of the distinction between self-executing and non-self-executing treaties, *see Foster and Elam v. Neilson*, 27 U.S. (2 Pet.) 253 (1829).

[80] The only exception would be if a treaty were to provide for termination by act of a national legislature.

[81] This sometimes occurs inadvertently when legislation is considered by members who are simply unaware of a conflicting treaty provision (as may be the case in this Committee's approval of the statute being considered in this hearing), but it also occurs occasionally even after the conflict with a treaty has been identified. An example of this that comes readily to mind was S-961, the "Magnuson Fisheries and Conservation Act," passed around 1976. *See* the minority views of my former employer, Senator Robert P. Griffin, included in the Foreign Relations Committee's report on this bill for a discussion of this problem.

[82] These may range from judicial settlement to reciprocal breach or simply the "horizontal enforcement" of retorsionary behavior to pressure our Country to observe its solemn international legal obligations (*pacta sunt servanda*).

Conclusion

MADAM CHAIRMAN, as I indicated when I began, I did not come here today with the intention of taking a definitive position on this legislation on the merits. I have primarily tried to set forth the basic international legal rules in my testimony, and I suspect that honorable men and women might reach different conclusions when applying those rules to this proposed statute.

One thing that does strike me as being fairly clear is that drawing a distinction between "emigration" and "expatriation" is not the answer. To deny the right of expatriation would conflict with centuries of precedent in U.S. practice of International Law, not to mention Article 15 of the Universal Declaration of Human Rights. It would be contrary to statutory declarations by Congress dating back more than a century, not the least of which is the 1974 Jackson-Vanik Amendment.

If this were merely a statute providing that citizens must "pay their lawful taxes" before they may renounce their citizenship and move to a foreign State they find more attractive, I think it could pass legal muster with little difficulty.[83] But I'm not sure that's the situation. You understand the tax system far better than I do, and I will defer to your expertise in the final analysis.

If the proposed "exit tax" is designed to discourage citizens from exercising their right to renounce US citizenship, I think it is contrary to the law. If it is designed to impose an immediate and substantial financial burden upon citizens—on the specific and expressed grounds that they have elected to renounce their citizenship and emigrate to another country—and it is a burden that would not be imposed upon otherwise identically situated citizens who elected to remain American citizens (and did not elect to sell or dispose of their property or take other action that would recognize capital gains liability), then I think you have a very serious problem. In that event, I would want my money "up front" if I were asked to argue before an international tribunal that the proposed US exit tax complies with the spirit of the Jackson-Vanik Amendment—which no less an authority than the United States Congress argued reflected the minimal requirements of International Law two decades ago. (I think I would base my Jackson-Vanik case upon the technicality that the United States is not covered because it does not have a "non-market economy"—but the underlying rule of customary international law is not so qualified and could not be evaded by that consideration.) Trying to argue that international human rights standards have *declined* since 1974 would clearly not pass the "straight face" test.

The experts are divided about whether the Jackson-Vanik Amendment is a "relic of the Cold War" and ought to be repealed.[84] Secretary of State Christopher and the Congressional Helsinki Commission have both voiced opposition to removing Jackson-Vanik from the statute books on the grounds, *inter alia*, that some "refuseniks" are still being denied the right to emigrate from Russia[85]; and the issue of freedom of emigration has also been central to the debate over MFN status for China.[86] It is simply unrealistic to believe that the underlying principle of freedom of emigration will no longer face serious challenges, and the ability of the United States to use moral suasion to further such important values may well depend in no small part upon the international perception of our own record in upholding these rights. As Jefferson noted in a 19 April 1809 letter to James Madison: "[I]t has a great effect on the opinion of our people and the world to have the moral right on our side."

Unless someone can do a better job that I have heard thus far in distinguishing an exit tax targeted at "super rich Americans" from one aimed at "educated Jews,"[87] you may ultimately find as a practical matter that you will need to make a choice between enacting this provision and attempting in the years ahead to uphold the Jackson-Vanik Amendment and similar fundamental human rights norms. If this provision is enacted into law, I believe the odds are good that future US protests calling upon China, Iraq (which last month imposed an exit tax of its own to curtain the flow of capital), Iran, and other flagrant human rights violators to comply with various

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[83] The Department of State, for example, has warned that "Persons considering renunciation [of US citizenship] should also be aware that the fact that they have renounced U.S. nationality may have no effect whatsoever on their U.S. tax or military service obligations." 87 AM. J. INT'L L. 602 (1993).

[84] For a useful summary of this debate (reaching the conclusion that "Jackson-Vanik has continuing relevance today," see Kevin M. Cowan, *Cold War Trade Statutes: Is Jackson-Vanik Still Relevant*, 42 U. KAN. L. REV. 737 (1994).

[85] *Id.*

[86] *See, e.g.*, Lucille A. Barale, *U.S. MFN Renewal for China: The Jackson-Vanik Amendment*, 12 E. ASIAN EXEC. REP'T 6 (1990); Randall Green, *Human Rights and Most-Favored-Nation Tariff Rates for Products from the People's Republic of China*, 17 U. PUGET SOUND L. REV. 611 (1994); and Marian Nash (Leich), *Contemporary Practice of the United States Relating to International Law*, 88 AM. J. INT'L L. 719 (1994); Executive Order 12,850 (1993).

[87] I hope I am not the only one who has been alarmed by the tone of some of the rhetoric in this debate. Indeed, if you but changed the nouns, some of the invectives now being directed against "super rich" Americans might easily be mistaken for Soviet diatribes against "Jews" a couple of decades ago.

provisions of the Covenant on Civil and Political Rights will receive in reply a counter-charge concerning American "violations" of Article 12—not to mention the Universal Declaration and our own Jackson-Vanik law.

In summary, last week's State Department testimony not withstanding, it has been the view of the United States government since George Washington was President that citizens of every State have a natural "right" to disavow their political connection with that State and to establish a citizenship relationship with another. That right is now a part of International Law, and it has been codified in American law for more than a century. The question each of you must answer is whether this proposed new "exit tax" places more than a nominal burden on the exercise of that right.

Unlike my friend Paul, I don't regard arguments on either side of this issue to be "inconceivable." On the contrary, I think you have a difficult task. But if I might inject a very personal element into the debate, I would urge you to move cautiously if you have any significant doubts about this provision's compatibility with International Law. Because, candidly, when I balance the importance of upholding international standards of human rights against the possibility of coming up with a billion dollars or so to help pay off the deficit, my personal values come down on the side of human rights every time.

MADAM CHAIRMAN, that concludes my prepared statement. I will be happy to attempt to answer any questions you or your colleagues might have.

Chairman JOHNSON. Thank you, Mr. Turner. I appreciate your very thoughtful testimony.

I think history does matter. I think the effort to be consistent with our own beliefs in different areas is important, and I appreciate your advice to be cautious.

I think it is particularly important in this era in which we just passed a GATT Agreement that is going to require the nations of the world to respect America's definition of the importance of individual property rights, both tangible and intellectual. I think it is very important that we be sure that we act consistently, particularly in regard to uniform values and uniform rights, and I appreciate your testimony.

Mr. Norman.

STATEMENT OF WILLIAM K. NORMAN, ESQ., PARTNER, ORD & NORMAN, LOS ANGELES, CALIFORNIA

Mr. NORMAN. Thank you. Madam Chairman and Members of the Subcommittee, I am here to testify in opposition to the proposal of the administration to impose a new tax on individuals who renounce their citizenship. I am appearing on my personal behalf.

I believe that the administration, the Department of Treasury and various Members of Congress who have been supporting the new proposed expatriation tax have failed to make the necessary public policy case. Only a political case has been made, not so much here today by Mr. Guttentag, but in the press releases and in the Senate hearings.

As a tax lawyer working in the field, I believe the tax policy implications of the proposal and the need for this tax need to be examined more closely. Congress should determine why our citizens are considering to expatriate in the first place.

You have asked today a member of the Treasury why they never issued regulations. I have to admit it is the first time I have ever heard the IRS say they haven't issued regulations because they thought the underlying law couldn't be enforced. We should ask why they haven't issued forms, special forms when people expatriate so we can identify who these 800 people who expatriated are, for instance, this year.

I think more time and more study and hearings are needed to determine if we as a country actually have an expatriation problem and if so, what is the appropriate response.

I think Congress probably had the power to enact the proposed tax or something like this tax, but we need to consider whether we should enact it, not just whether Congress has the power, if we just modify it here and there. Tax motivated expatriation can be discouraged through more positive measures.

Just from my own practice, the lowering of capital gains rates would make a big difference, if not eliminate the motivation for a great many of these people who do expatriate for tax reasons; more effective estate tax deferral provisions when you have deaths with a closely held business would also help.

Congress should also recognize, as has been mentioned here earlier in the Chair's remarks, that dual citizens, U.S. and foreign country citizens, often have legitimate nontax motivated reasons

for renouncing their U.S. citizenship and retaining a foreign country citizenship.

In particular, I suggest that the proposed tax should not be adopted for three reasons. They are in my prepared remarks, but I'd like to summarize them. First, I think it is bad tax policy with likely detrimental economic consequences. Some of our most successful individuals that do not yet have a high net worth or appreciation in their assets will now have a new threshold that is going to get them thinking about whether they should expatriate or not. Because if they build up too high a net worth in the United States, they will be subject to a limitation if they ever leave the country.

There are a large number of people, at least in my practice, who have left—largely in terms of my own total experience—who have renounced not for tax-motivated reasons principally, but for patriotic or personal political allegiance or religious reasons. We are talking about individuals going to Ireland, Israel and some of the Eastern bloc countries. These possibilities with the cold war essentially over and the gulf war resolving questions of political military power in the Middle East have opened up possibilities for many of our dual citizens that were not present before or were unthinkable before.

Second, the proposed tax will discourage foreign resident individuals from becoming long-term residents, if that is the coverage of the proposal, or long-term residents from becoming naturalized citizens. We are going to have a class of wealthy aliens who are residents and who are going to be afraid just for protection of their family and for economic reasons to seek U.S. citizenship, because once they are in the system, they never can leave, they can never make that choice to go back home if their circumstances change.

Wealthy foreign individuals who consider countries to which they emigrate, and there are large numbers of these each year, certainly from the Far East and Asia that we see in California, are going to stay away from a country that seems to need an exit tax or what is perceived to be an exit tax, and not get into what in fact this tax really is, or needs such a tax to keep its citizens home. That tax is just not going to be attractive. It is going to be discussed in international seminars. It is going to be in the South China Morning Post. It is going to be something that is going to be well known to this class of individuals throughout the world.

The United States is going to continue to lose out in competition for the economically successful emigrants. It is already losing out to Canada, a much smaller country that has many more immigrants coming to its shores. Canada, even though it has a so-called exit or departure tax, does have special reliefs for immigrants.

A third—I think the proposal represents a major departure in Federal tax policy. We need to think about what this means in terms of our tax treaty relationships. Time is needed to renegotiate these treaties. We just finished a long negotiation with Canada where we had to accommodate their capital gains tax which is a form of exit or departure tax with our own estate and gift tax sections. It is just difficult and takes time if we are going to go this route.

We don't know what the real policy basis is for these various thresholds and why foreign assets are in the base. They were not

essentially in the base under section 877, the section we are talking about. Why is there no indexing of the exemption amounts? Why do we treat—rather, why don't we treat all expatriates the same instead of only those with appreciated assets? Maybe the threshold should be on net taxable estate. We are talking about the superrich leaving. Why not use something like a net worth of $10 million which is where our highest estate tax rates come in.

In the meantime, I think we ought to encourage the IRS to enforce the current law. They should issue regulations. They should develop compliance procedures.

If we must change 877 because it is not enforceable, I have some suggestions which are not in my remarks, but just bear with me for a moment. We could change the presumption of correctness in the statute, so that the determination of the IRS, as they have in intercompany pricing cases under section 482, would be presumed correct. It would be up to the taxpayer to show he didn't have a tax motivation.

We could have regulations that define tax avoidance. The Treasury just did this in proposed form with respect to the multiparty financing regulations under section 7701. They define what a tax avoidance plan is.

We could have reporting at the time of expatriation, or require a statement supporting why the expatriation is not for tax avoidance purposes. We have similar statements now with respect to nonaliens who claim to have a closer connection with a foreign country. They have to file a statement.

We could provide that these individuals will continue to be treated as residents of the United States if they stay or have a physical presence in the United States beyond 90 days in the next 3 years, so we know they really have gone and they really are serious about their expatriation.

We could even have changes in our immigration law. These people should have to go to the back of the line so that they don't come back and get green cards and even citizenship in some short period of time. Maybe a 5-year period where they couldn't apply for a green card. Why should they expatriate and then have them come back through our system?

I think just to close up, there are very few dual citizens who will make the choice to go to a foreign country. But I think we have to respect the fact that for some individuals who do not have tax motivation, that in their own view, it is the right choice, and we should respect it.

Our country was founded on people who made such a choice, and those who made the wrong choice, if you go back and look at history, went to the Bahamas or Bermuda. These very places that were mentioned in the Forbes article that the Treasury representative referred to. But look how many people are there, a handful, and just a handful are ancestors of these people who made that choice at the time our country was founded.

That concludes my statement.

[The prepared statement follows:]

PREPARED STATEMENT

of

William K. Norman, Esq.
Partner
Ord & Norman
Attorneys at Law
Los Angeles, California

Before
Committee on Ways and Means
Subcommittee on Oversight
U.S. House of Representatives

Room 1100 of the Longworth House Office Building

Monday, March 27, 1995

Madam Chairman and Members of the Subcommittee, I am here to testify in opposition to the proposal of Administration to impose a new tax on individuals who renounce their United States citizenship. I have in the past represented individuals who have renounced their United States citizenship or surrendered their green cards. I and my firm currently represent clients who have an interest in the proposal relating to expatriation before the Subcommittee today and the other proposals relating to foreign trusts contained in the original proposal of the Administration released on February 6, 1995. I am testifying here today on my own behalf and I am personally bearing the expenses of preparing my statement and appearing here today.

I believe that the Administration, Department of the Treasury and various members of Congress supporting the new proposed expatriation tax have failed to make the necessary public policy case for their proposal. Only a political case has been made. The new tax is technically not a tax on change of residency or on travel itself. It is in essence a tax targeted against the dual citizen who chooses to become a citizen of only one country, a foreign country, rather than the United States. As a tax lawyer working in the field, I believe the tax policy implications of the proposal need to be examined more closely. Congress should determine why our citizens are considering expatriating in the first place. The Internal Revenue Service should be asked why it has never embarked on serious enforcement efforts in this area. Specifically, the IRS should be asked why it has never issued regulations under the existing Internal Revenue Code provisions dealing with expatriation or why it has never required special forms to be filed at the time of expatriation.

More time, including hearings, are needed to determine if we, as a country, actually have an expatriation problem and, if so, what is the appropriate legislative response, if any. If Americans for tax reasons are in fact leaving this country and abandoning their citizenship in crisis numbers, it cannot be for the healthcare facilities in Belize or Nevis or the low taxes in Australia, Canada or the United Kingdom. Congress should not devise and enact legislative solutions to nonexistent crises or to a crisis not understood. Did not the voters in 1992 and in 1994 send a clear message that Congress and the President should find real solutions to real problems? Even if a new tax seems warranted, we need to consider the international implications, *i.e.*, how will the proposed new tax mesh with the tax systems of other countries, especially the tax systems of our treaty partners. Congress probably has the power to enact the proposed tax but it needs to consider carefully whether it should do so. Tax motivated expatriation can be discouraged through more positive measures such as lowering the capital gains tax rates. Congress should recognize that dual citizens often have legitimate non-tax motivated reasons for renouncing United States citizenship and retaining a foreign country citizenship.

The new tax as proposed should not be adopted for the following three reasons:

First, the imposition of an exit tax on certain U.S. citizens who renounce their citizenship is bad tax policy with likely detrimental economic consequences. Some of our most successful individuals will be encouraged to expatriate before they build up the threshold levels of appreciation in their assets. Further, the new provision is unfair to dual citizen individuals who seek to renounce their United States citizenship and return to their homeland either for patriotic or religious reasons. If somebody is going to move abroad and become, for example, politically active in Ireland or Israel, why should they retain their United States citizenship? The individual is not an economic traitor to this country. The individual is merely being true to his

or her own beliefs and heritage. Only a handful of individuals, perhaps a dozen, will be annually subject to significant levels of tax under the proposal. Surely, a less radical approach can be found.

Second, the proposed tax will discourage foreign resident individuals from becoming long term residents of the United States and long term resident aliens from becoming naturalized U.S. citizens. Specifically, resident aliens will be encouraged to remain United States residents for economic reasons and not seek United States citizenship. Once an alien becomes a U.S. citizen, he will not be able to remove himself from the U.S. tax system without being subject to tax on the appreciation in his assets provided the thresholds are reached. The United States will be sending the wrong message to the potential immigrants. Wealthy foreign individuals considering countries to which to immigrate will be shy of a country that needs an exit tax to keep its citizens home. In general, the United States will continue to lose out in the competition for economically successful immigrants to Canada, Australia and others. For example, even though Canada imposes a tax somewhat like the proposed exit tax, it provides a fresh start in the form of a new basis for the assets of its immigrants. Further, Canada permits establishment of pre-immigration foreign trusts to avoid Canadian taxation on income derived from assets acquired by an immigrant before he or she establishes Canadian residency.

Third, since the proposal represents a major departure in federal tax policy, a detailed study is warranted. In this connection, a number of matters should be studied. Consideration should be given to providing a grace period in order that the United States will be able to renegotiate its income tax treaties to accommodate this new system. The United States just went through a rather long period of negotiation with Canada to accommodate the Canadian capital gains tax with our own estate and gift tax system. Additionally, a stronger policy rationale for the coverage and exemptions in the proposal needs to be developed. Should only U.S. citizens be covered? Should short term and long term residents be covered? What is the policy basis for the various thresholds or exemption amounts? Why are foreign assets even in the tax base? Why is there no indexing of the exemption amounts? Why are not all expatriates treated the same, instead of only those owning assets with the threshold amounts of appreciation? Perhaps the threshold should be based on net taxable estate and not on a specified amount of built-in appreciation. Further, consideration should be given to providing a February 6, 1995 fresh start tax basis for all taxpayers who become subject to the tax. Finally, if the proposed tax is intended only to be imposed on the very rich, why not increase the threshold amount to persons with net asset values of $10 million dollars or more -- the levels where the very top United States estate tax rates are imposed.

In the meantime, Congress should encourage the IRS to enforce the current law concerning tax motivated expatriation. Congress should ask the IRS to issue regulations, just as Congress has done a number of times with respect to inter-company pricing. Congress should ask the IRS to develop compliance procedures that will help it identify cases of expatriation that are tax motivated and subject to the current regime in the Code. The IRS could develop a procedure for "quarantining" United States assets at the time of expatriation so that the tax imposed under existing Section 877 will be collected at the time there is a realization event. Finally, Congress should ask the IRS to add these projects to its current 1995 business plan.

In 1966, Congress apparently enacted the existing Code Section 877 dealing with tax motivated expatriation because it believed it was at the same time making the United States tax laws too attractive for nonresident aliens. Now in 1995, a handful of U.S. citizens apparently believe that our tax laws have made it too burdensome for them to remain American citizens. If this is so, how can enacting a new tax, a tax on the freedom to abandon dual citizenship be ameliorative? Congress should find out why some U.S. citizens are considering expatriating while at the same time immigration to this country is at a record high. If the policies of our country are driving our rich citizens to expatriate and encouraging the alien poor to immigrate, we certainly have a problem. If such a problem exists, careful congressional study is called for. Any legislative solution needs to be carefully crafted.

The use of the proposed new tax on expatriates as a favorite revenue offset is not responsible given the serious harm that may result from the enactment of the proposal as currently formulated. We need a "Stay American" and "Invest American" Tax Incentive Act and not an Act that will make Americans the pariah of the world's rich, successful and entrepreneurially able. We should not wage economic warfare on some of our most successful citizens and residents and call them "Economic Benedict Arnolds." Even those who give up United States citizenship or long term residency should not be discouraged from investing in the United States. Finally, those wealthy aliens currently living abroad seeking a country to which to immigrate should not be discouraged by a U.S. tax system hostile to change in residency or even citizenship. We live in a world of change.

Mr. HANCOCK. I want to take this opportunity to underline, Madam Chairman, if you would yield, this one sentence that you have in your testimony, Mr. Norman. It says, If the policies of our country are driving our citizens to expatriate and encouraging the alien poor to immigrate, I mean we really have a problem. And I don't think you meant—you should have emphasized that a lot more.

Mr. NORMAN. I was trying to tone down the rhetoric in response to the other Member.

Chairman JOHNSON. Mr. Heller.

STATEMENT OF LAWRENCE H. HELLER, ESQ., PARTNER, WHITMAN BREED ABBOTT & MORGAN, LOS ANGELES, CALIFORNIA

Mr. HELLER. Thank you.

Madam Chairman and Members of the Subcommittee, I am here today to testify in opposition to to the President's budget proposals to impose a tax on U.S. citizens who renounce their citizenship and long-term resident aliens who give up their resident status. I am testifying in my personal capacity.

I would like to submit my statement for the record, and will take this opportunity now to summarize some of the key elements of my statement.

I feel that the administration's proposal is deficient and unnecessary for several reasons, many of which we have heard today. I feel the most compelling are, number one, the Treasury has failed to issue regulations or take any serious measures to improve enforcement of section 877. We have talked about that many times today. We have an existing statute. The statute has been around for almost 30 years, and yet testimony by Treasury and other witnesses has confirmed that nothing has been done about it. Let's use that statute, let's take a look at it and see how it can be used to put a—or to work with some of the perceived problems.

Number two, the proposal fails to recognize the need for the international coordination of taxes. This is a complex area, and it needs further study and analysis. The proposal fails to—excuse me. The revenue estimates are based on flawed assumptions and are thus incorrect.

And finally, the proposal fails to recognize and adequately address the various administrative problems that will result from the new tax regime.

With regard to section 877, as I have indicated before, and this is the current statute, I find no evidence to support the proposition that the existing rules have been tested and are ineffectual. These expatriation tax rules were originally enacted over 30 years ago, as I have indicated. What were they designed to accomplish?

These rules were designed in section 877, which is attached as an exhibit to my statement, to impose a tax on U.S. citizens who expatriate. That is what we are talking about today. Basically, it was designed to impose a tax over a 10-year period in areas that are not otherwise covered by the normal tax regime. Non-U.S. taxpayers are only taxed on their U.S.-source income.

The 877 went one step further and attempted to impose a tax on U.S. citizens who expatriate by adding a restriction and imposing

a tax on their assets that are sold during that 10-year period, assets that may otherwise not be subject to taxation. This was the purpose of the statute in 1966. It is covered by the Committee reports.

Why does the Treasury feel that this section needs to be overhauled? As one of their reasons they have cited that the burden on the Treasury is too onerous to establish the tax avoidance motive. Well, let's look at that. There are several situations where in the past the burden has been shifted. Maybe we ought to take a look at shifting the burden to the taxpayer or, as Mr. Norman indicated, providing guidance so that we know under what situation the burden will be imposed.

The imposition of tax must wait until the property is actually sold, requiring the IRS to monitor these transactions. That is another perceived problem with the current section 877. Well, in the Treasury's own testimony, they have indicated that this would be a problem with the new proposed section 877.

There are many ways to monitor the transaction short of issuing an exit tax. An interim measure is a little bit of an overkill when the current statute hasn't even been utilized.

I won't go into the details now, but if you look at my statement, I have indicated ways that the IRS and the Department of State can coordinate their efforts to monitor the expatriating citizens and to find out who is paying their taxes and who isn't, who is filing returns and who isn't.

Mr. Norman indicated, and I support the idea of filing a statement when you expatriate and providing the IRS with information. After all, this is a voluntary tax system. We do base our entire system on voluntary compliance.

As I have indicated, the proposal fails to recognize the need for international coordination of taxes. Much has been said about this. I will only state that I feel this requires considerable study. Analysis needs to be made of the various tax treaties.

I think there is a serious problem involved with double taxation. If you tax the U.S. citizen now and then when he sells his assets, when he is a resident of another country, he is going to be subject to a second tax, without the ability to use any of the credits that are now available. This is going to create a real treaty problem, and I think maybe it can be worked out and maybe not. But it is part of the administrative nightmare that we are looking at.

What about the fact that we are trying to tax our citizens on a nonrealization event? Take the hypothetical situation of Mr. A who has an interest in the closely held corporation. If he expatriates, then he may be forced to pay the tax without having the cash to—or the cash flow to pay the tax. Where is he going to get the tax? Where is he going to get the funds? Is he going to have to liquidate his business? Is he going to have to borrow from the bank? Is this going to further skew our national economy? Yes.

The Treasury has suggested that maybe under certain circumstances, specifically section 6166 of the Internal Revenue Code, this individual would be able to defer his tax, maybe 5 or 10 years. But he is deferring his tax, he is still paying interest on that deferral, and if you look at section 6166, it is not a full deferral, but it

is basically an installment payment of the taxes. So it doesn't solve the problem at all.

Somebody mentioned earlier today that death is a nonrealization event. Well, that is true. However, as an estate planner practicing in this area for over 25 years, we learn to plan to pay for the taxes in the event of death. Life insurance is available, and there are other planning techniques that help eliminate this nonrealization event and provide for the liquidity that is necessary in the situation. There is no liquidity provided with this exit tax that is being proposed by the Treasury.

We are very aware of the flawed revenue estimates and the assumptions here. I haven't heard anything today that changes my concerns in this area. I feel that there is nothing that really has convinced me that the $970 million that have been projected by the Treasury to raise in 5 years from the 24 taxpayers will ever be realized. So I think this is a real concern and something that has to be fully analyzed.

Finally, I think that we have to look at ways to encourage our citizens to stay here, fix the problems at home, reduce the capital gains rates as an example, work on our other problems. Let's see why these citizens are leaving; let's conduct studies in this area.

I think that with the proper analysis and the proper study, we can work together to solve the problem that can be readily solved without taking these extreme measures.

This concludes my remarks and I will be glad to answer any questions.

[The prepared statement and attachment follow:]

PREPARED STATEMENT

OF

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CHAIR, INTERNATIONAL, PROPERTY, ESTATE AND TRUST LAW
COMMITTEE
SECTION OF INTERNATIONAL LAW AND PRACTICE
AMERICAN BAR ASSOCIATION

(TESTIFYING IN PERSONAL CAPACITY)

BEFORE

COMMITTEE ON WAYS AND MEANS
SUBCOMMITTEE ON OVERSIGHT
UNITED STATES HOUSE OF REPRESENTATIVES

ROOM 1100 OF THE LONGWORTH HOUSE OFFICE BUILDING

MONDAY, MARCH 27, 1995

Madame Chairman and members of the Subcommittee, I am here today to testify in opposition to the President's FY 1996 budget proposals to impose a tax on United States citizens who renounce their citizenship and long-term resident aliens who give up their resident status. I am testifying in my personal capacity as a partner in the law firm of Whitman Breed Abbott & Morgan.

Under the Administrations's proposal, if, after February 6, 1995, a U.S. citizen relinquishes his or her citizenship, property held by that person would be treated as sold at fair market value immediately before such expatriation. This "deemed realization" provision would also apply to a "long-term resident" defined, under the proposal, as an individual who had been a lawful permanent resident of the United States (i.e., a green card holder), other than an individual who was taxed as a resident by another country under a treaty tie-breaker rule, in at least ten of the prior fifteen taxable years. For this purpose, property that would be treated as sold would include all items of property (with the exception of certain U.S. real property interests and interests in domestic retirement plans) that would be included in the individual's gross estate under the Federal estate tax if such individual were to die on the day of deemed sale. In addition, certain trust interests would be subject to the new rules.

On March 15, 1995, the Senate Committee on Finance adopted a modified version of the Administrations proposal as an amendment to H.R. 831, a bill extending the health insurance deduction for the self-employed. Under Section 5 of H.R. 831 the proposal's application to resident aliens was eliminated and the effective date for the renunciation of citizenship was clarified to be the date the individual initiated the process with the State Department. H.R. 831 also attempted to clarify the treatment of beneficial interests held in trusts by expatriating citizens.

The Administration's proposal is deficient and unnecessary for several reasons, the most compelling of which are that: (i) the Treasury has failed to issue regulations or take any serious measures to improve enforcement of section 877, (ii) the proposal fails to recognize the need for the international coordination of taxes, (iii) the revenue estimates are based on flawed assumptions and are, thus, incorrect and (iv) the proposal fails to recognize and adequately address the various administrative problems that will result from the new tax regime.

I. **Failure to Recognize That the New Law is Not Necessary Given the Lack of IRS Efforts With Respect to Existing Provisions.**

I find no evidence to support the proposition that the existing rules under current section 877 (see Exhibit "1") have been tested and are ineffectual. These expatriation tax rules were originally enacted in 1966 and in the almost 30 year period since, the Treasury has failed to enact any regulations interpreting Section 877 or provide any guidance for their application. Furthermore, the tax reasons for expatriating are overstated and the disincentives to move to low tax jurisdictions are understated.

Despite this lack of prior attention to the current section 877, the Treasury has concluded that section 877 does not work[1] and needs to be overhauled, citing as its reasons: (i) that the burden on the Treasury to establish that the taxpayer has a tax avoidance motive is too onerous, (ii) since current section 877 only applies to U.S. source income, it is subject to abuse because taxpayers are able to convert U.S. source income into foreign source income and avoid tax altogether, (iii) the rules are extraterritorial in nature and, thus, may unfairly tax the expatriate for post relinquishment U.S. source income earned during the ten year period, and (iv) the imposition of the tax must wait until the property is actually sold requiring the IRS to monitor transactions that occur long after an individual relinquishes his citizenship.

Burden of proof with respect to the tax avoidance motive. I find no merit in the Treasury's position that the burden of establishing that the taxpayer has a tax avoidance motive is too onerous.[2] At the outset, the scope of the Treasury's burden of proof should be examined, in light of what is *not* required. The Commissioner's burden under current Section 877 is *not* to establish that the loss of citizenship did not have as one of its principal purposes the avoidance of U.S. income, estate or gift taxes, but rather the Treasury Department must establish that it is *reasonable* to believe that the expatriate's loss of U.S. citizenship would, but for the application of section 877, result in a substantial reduction in the U.S. tax based on the expatriate's probable income for the taxable year (sec. 877(e)). Establishing this reasonable belief shifts the burden of proving that the loss of citizenship did not have as one of its principal purposes the avoidance of U.S. income, estate or gift taxes to the taxpayer.

Furthermore, even if there was a legitimate basis for the Treasury's position, current section 877 could be amended to shift the burden of proof to the expatriating citizen from the outset.

Ability to convert U.S. source income to foreign source income. The Treasury is concerned because taxpayers may be able to convert U.S. source income subject to the tax under current section 877 to foreign source income that is not subject to the tax and that some practitioners advise their clients on ways to accomplish this conversion in a manner that purports to avoid section 877. Even if this was a legitimate problem, less draconian measures are available such as amending current law, i.e., section 367 or issuing regulations under existing section 877.

Post emigration gains should not be subject to U.S. taxation. The Treasury believes that[3], since existing ten-year expatriation rules are extraterritorial in nature, and therefore, tax gains accruing between expatriation and the sale of the asset, it is unfair to tax an expatriate who purchased U.S. stock the year after he relinquished his citizenship and sold

the stock eight years later. I hardly find this to be a compelling reason to change the existing provisions and arguably, it is just as unfair to impose an exit tax on the same person before there has been a realization event.

Monitoring post relinquishment sales. The Treasury is concerned that the requirement of current law that the imposition of the tax must wait until the property is actually sold requires it to monitor transactions that occur long after an individual relinquishes his citizenship.[4] The above notwithstanding, coordinated efforts among the IRS, the State Department, Custom Service and Immigration and Naturalization can improve enforcement of the current section 877. Currently, the IRS does not request the Department of State to regularly provide lists of Americans who renounce their citizenship. Such a list could be cross-matched against the IRS's listing of "stop filers," that is, those taxpayers who do not file an income tax return in a year subsequent to having filed an income tax return. While thousands of stop filers result from death of the taxpayer or retirement from the labor force, matching citizenship relinquishment against stop filers who had reported income above a certain level in the prior year, or prior several years, may indicate taxpayers who relinquished citizenship with a tax motivation.

With coordinated notification efforts, the IRS can determine whether an expatriate possesses any assets within the United States that could be seized to satisfy the tax liability in situations where a concern that the revenue may not be collected exists. Seizure of assets for failure to pay taxes is permitted under present law. Also, the IRS could coordinate with the Customs Service and Immigration and Naturalization Service to detain noncompliant expatriates who attempt to re-enter the United States. Present law would permit such coordination for purposes of collecting taxes assessed under section 877, if the IRS would seek to assess and collect such taxes.

II. **The Proposal Fails to Recognize the Need for International Coordination of Taxes.**

I do not intend to dwell on the public policy arguments that have been raised by those who consider the proposal to be draconian and nothing more than an "exit tax" on emigrating U.S. citizens and long-term residents aliens.[5] Rather, my concern is that, without responsible fiscal analysis and review of the broad policy and international implications of these proposals, the impact of creating a negative image in the international community may outweigh any hypothetically perceived revenue returns. Imposing an exit tax on U.S. citizens sends the wrong signals to the international community. The proposal is already having serious repercussions outside the United States with some wealthy foreigners even considering divesting their U.S. investments.[6]

The broad policy implications do not stop there. There will be a need to mitigate the double tax effects in the new jurisdiction upon the actual subsequent sale of assets by the departing taxpayer and there will be a need to thoroughly analyze and renegotiate treaties to accommodate timing differences. The proposal also fails to provide transitional relief for bonafide dual citizens.

III. **Failure to Recognize the Administrative Problems.**

The administrative problems raised by the proposal are considerable. Without a "realization event," extra resources must be devoted to determining the value of the assets of the taxpayer who is relinquishing his or her citizenship. Additional costs will be involved since, in many circumstances, professional appraisals will be necessary, thereby adding additional expense to a taxpayer who may already be burdened with "cash flow" problems.

Imposition of an Income Tax where there is a Nonrealization Event.

A taxpayer should not be required to pay income tax until there has been a sale or other disposition of property. Under the proposal, a U.S. citizen who relinquishes citizenship generally is treated as having sold all of his property at fair market value immediately prior to the day of expatriation. Gain or loss from the deemed sale is recognized at that time, generally without regard to other provisions of the Code. Such a provision puts an undue cash flow and liquidity burden on the taxpayer. Taxing unrealized gains also mismatches the timing of U.S. and foreign income tax so that foreign tax credits will not be effective to prevent double tax.

Further study is required for many reasons. Additional time is needed for coordination with both domestic and foreign estate and gift tax rules. The proposal fails to impose any obligations on the IRS to issue regulations. An analysis should be made and a study undertaken to determine the hidden costs of enforcement of the new provisions. Like present law, absent enforcement initiatives by the IRS, the proposal relies on the voluntary compliance of expatriating citizens. The major change in terms of voluntary compliance is to deem all expatriates with certain accrued capital gains in excess of $600,000 liable for tax. Where present law requires the expatriate to make a judgement about whether his relinquishing of citizenship was tax motivated and then file returns for the subsequent 10 years, the proposal requires the expatriate whose accrued gains exceed the threshold to file a tax return within 90 days of expatriation. The IRS can expect disputes over valuation of assets that are deemed to have been sold when no transaction, in fact, took place. This will result in additional costs in terms of auditors and other IRS personnel.

Jeopardy Assessment. The proposal raises several other administrative questions. First, is the proposal necessary in light of the jeopardy and termination assessment procedures already available under Sections 6851 et seq. of the IRC? Under the jeopardy and termination assessment procedures, the IRS may assess the taxpayer's tax and immediately commence collection if: (i) it appears that the taxpayer is or appears to be designing to depart quickly from the United States or to conceal himself; (ii) if the taxpayer is or appears to be planning to quickly place his assets beyond the reach of the IRS; or (iii) if the taxpayer's financial solvency is or appears to be imperiled. If the IRS makes a jeopardy or termination assessment based on reasonable grounds that suggest one of the above-referenced situations is taking place, it must provide the taxpayer with a written statement setting forth the information which the IRS used in making the assessment. The taxpayer then has the earlier of (a) thirty (30) days from the receipt of the written statement or (b) thirty-five (35) days from the date of the assessment to file an administrative appeal. Failure to file such an appeal will permit the IRS to proceed with enforcement procedures to collect the unpaid taxes.[7]

Consequently, if the IRS is notified by the U.S. State Department of U.S. citizens seeking to relinquish their citizenship or by the Custom Services or the Immigration and Naturalization Services of U.S. of aliens seeking to leave the United States, the IRS could then utilize the jeopardy and termination assessment procedures to collect necessary taxes. However, the IRS has not requested the State Department to regularly provide lists of Americans who renounce their citizenship. Such a list could be cross-matched against the IRS's listing of "stop filers" to determine which taxpayers may have relinquished citizenship with a tax motivation.

Conflict between Sections 6851 et seq.and the proposal.

Under the proposal, an individual who is subject to the tax on expatriation is required to pay within ninety (90) days a tentative tax equal to the amount of tax that would have been due based on a hypothetical short tax year that ended on the date the individual relinquished his citizenship. On the other hand, under the jeopardy and termination assessment procedures, the IRS could enforce collection actions within thirty (30) days after giving notice to the taxpayer. Presently, there is no provision in the

jeopardy and termination assessment procedures, the existing law (under the current section 877) or the proposal that addresses this conflict.

In this regard, the U.S. Senate's Joint Committee on Taxation released a report (JCX-14-95) on taxation of U.S. citizens who relinquish citizenship which suggests that Section 877 would govern over the jeopardy and termination assessment procedures. At the end of Part II of the report, the Committee acknowledges that the Senate-modified section 877 "would replace the current 'sailing permit' requirement under Section 6851(d) of the jeopardy and termination assessment procedures with a new requirement to file a short-year tax return" (i.e. the ninety (90) day filing requirement of Section 877). Section 6851(d) and the regulations thereunder currently require any alien who leaves the United States, regardless of the duration of the trip, to obtain a certificate from the IRS District Director showing that the alien has complied with all U.S. income tax obligations before the alien can leave the country. Obviously, compliance with this requirement is infrequent. Under H.R. 831, however, any alien who leaves the United States would be required to file a tax return and pay the relevant tax within ninety (90) days of the date that the alien ceases to be a U.S. resident. Nothing would be required of a resident alien who returns to the United States as a resident within ninety (90) days of departure or otherwise maintains U.S. residence.

The Joint Committee's interpretation that H.R. 831 would govern over Section 6851(d) would appear to be equally applicable in instances involving U.S. citizens who relinquish their citizenship. Thus, pursuant to the Joint Committee's analysis above, the tax liabilities of a U.S. citizen who relinquished his citizenship would be governed by H.R. 831 instead of the jeopardy and termination assessment procedures.

IV. **Failure to Recognize the Flawed Assumptions Under which the Revenue Estimates were Made.**

If the Administration's proposal becomes law only the marginal taxpayer will continue to expatriate, thereby eliminating any immediate significant sources of revenue. Even if wealthy U.S. citizens continue to emigrate, the revenue impact can hardly be significant. In fact, according to the Treasury's own estimates[8], wealthy taxpayers are emigrating at the rate of only two dozen per year. Taxing our citizens a dozen at a time can hardly justify the use of the legislative and administrative resources that will be called to bear. The negative image and mixed signals that this will give to the rest of the world and the international community by imposing such an exit tax hardly compare with the hypothetical revenue increases. Consideration should thus be given to the revenues lost by discouraging high net worth foreign individuals from immigrating to the United States.

Other concerns include the fact that the high cost of administration has not been reflected, losses from discouraging domestic investment by wealthy foreign individuals needs to be considered, and losses from United States citizens encouraged to plan for low appreciation in their assets and future high income potential may be a factor to consider, as well as does the loss from entrepreneurs and high income potential (for current low net worth) citizens who expatriate before developing a high net worth.

V. **Other Solutions Exist**

A. "Quarantine" U.S. assets at time of expatriation and impose tax at time realization event occurs. U.S. assets may be "quarantined," *e.g.*, QDT and tax imposed only upon a subsequent realization event.

B. Reduce capital gains rate to eliminate motivation.

C. There is no public policy rational for the proposed exemption: foreign vs. domestic pensions, foreign assets in tax base, no indexing of exemption amounts, all expatriates should be treated the same.

D. Authorize IRS to conduct study and issue anti-abuse regulations under current law.

E. Apply tax only to appreciation occurring after February 6, 1995.

F. Provide the tax is not applicable to existing dual citizens for five years.

G. Provide the tax is not applicable to individual who become citizens of a treaty country for five years.

H. Additional suggested changes to current proposal.

i) Foreign personal residences and foreign pension plans should be exempt. More than 5 years should be allowed to pay tax attributable to business interests.

ii) Basis adjustments for U.S. tax purposes should be provided for in the statute without the need for implementing regulations, which may not be forthcoming for many years.

iii) Heretofore, jurisdiction to tax was based on citizenship or residency at the time a realization event occurs. If this principle is to be abandoned and gains that accrue during the period of U.S. citizenship are to be taxed in the U.S. without regard to citizenship or residency at the time of sale, gains that accrued to persons prior to becoming U.S. citizens similarly should be exempt from any U.S. income tax.

FOOTNOTES

1. Statement of Assistant Secretary of the Treasury (Tax Policy), Leslie B. Samuels, delivered during the Oversight Committee of Finance of the United States Senate hearings on March 21, 1995.

2. There are numerous civil provisions in the Code that explicitly place the burden of proof on the Commissioner in specifically designated circumstances: (a) Fraud. Any proceeding involving the issue of whether the taxpayer has been guilty of fraud with intent to evade tax (secs. 7454(a); 7422(e)). (b) Foundation Managers. Any proceeding involving the issue of whether a foundation manager has knowingly participated in prohibited transactions (sec. 7454(b)). (c) Transferee Liability. Any proceeding in the Tax Court to show that a petitioner is liable as a transferee of property of a taxpayer (sec. 6902(a)). (d) Review Of Jeopardy Levy Or Assessment Procedures. Any proceeding to review the reasonableness of a jeopardy levy or jeopardy assessment (sec. 7429(g)(1)). (e) Property Transferred In Connection With Performance Of Services. In the case of property subject to a restriction that by its terms will never lapse and that allows the transferee to sell only at a price determined under a formula, the price is deemed to be fair market value unless established to the contrary by the Secretary (sec. 83(d)(1)). (f) Illegal Bribes, Kickbacks, And Other Payments. As to whether a payment constitutes an illegal bribe, illegal kickback, or other illegal payment (sec. 162(c)(1) and (2)). (g) Golden Parachute Payments. As to whether a payment is a parachute payment on account of a violation of any generally enforced securities laws or regulations (sec. 280G(b)(2)(B)). (h) Unreasonable Accumulation Of Earnings And Profits. In any Tax Court proceeding as to whether earnings and profits have been permitted to accumulate beyond the reasonable needs of the business, provided that the Commissioner has

not fulfilled specified procedural requirements (sec. 534). (i) Expatriation. As to whether it is reasonable to believe that an individual's loss of citizenship would result in a substantial reduction in the individual's income taxes or transfer taxes (secs. 877(e); 2107(e); 2501(a)(4)). (i) Public Inspection Of Written Determinations. In any proceeding seeking additional disclosure of information (sec. 61 10(f)(4)(A)). (k) Penalties For Promoting Abusive Tax Shelters, Aiding And Abetting The Understatement Of Tax Liability, And Filing A Frivolous Income Return. As to whether the person is liable for the penalty (sec. 6703(a)). (l) Income Tax Return Preparers' Penalty. As to whether a preparer has willfully attempted to understate tax liability (sec. 7427). (m) Bankruptcy Claims. As to whether the IRS has a valid claim against the debtor's assets in any bankruptcy proceeding (11 U.S.C. 3001(f)). (n) Status As Employees. As to whether individuals are employees for purposes of employment taxes (sec. 530 of the Revenue Act of 1978).

3. See Samuels, Endnote 1.

4. See Samuels, Endnote 1.

5. See Robert F. Turner's statement during the March 21, 1995 Senate Finance Committee hearings and his discussions of the Jackson-Vanik right of emigration Amendment.

6. Statement of Marshall J. Langer delivered during the Oversight Committee of Finance of the United States Senate hearings on March 21, 1995.

7. Obviously there are numerous other procedural steps involved in jeopardy and termination assessments (e.g. time for appeals, judicial review). Notwithstanding, the principal of jeopardy and termination assessments provides an alternative method to collect taxes currently lost to expatriation.

8. See Samuels, Endnote 1.

EXHIBIT "1"

[¶ 28,120] EXPATRIATION TO AVOID TAX

Sec. 877 [1986 Code]. (a) IN GENERAL.—Every nonresident alien individual who at any time after March 8, 1965, and within the 10-year period immediately preceding the close of the taxable year lost United States citizenship, unless such loss did not have for one of its principal purposes the avoidance of taxes under this subtitle or subtitle B, shall be taxable for such taxable year in the manner provided in subsection (b) if the tax imposed pursuant to such subsection exceeds the tax which, without regard to this section, is imposed pursuant to section 871.

(b) ALTERNATIVE TAX.—A nonresident alien individual described in subsection (a) shall be taxable for the taxable year as provided in section 1, 55, or 402(d)(1), except that—

(1) the gross income shall include only the gross income described in section 872(a) (as modified by subsection (c) of this section), and

(2) the deductions shall be allowed if and to the extent that they are connected with the gross income included under this section, except that the capital loss carryover provided by section 1212(b) shall not be allowed; and the proper allocation and apportionment of the deductions for this purpose shall be determined as provided under regulations prescribed by the Secretary.

For purposes of paragraph (2), the deductions allowed by section 873(b) shall be allowed; and the deduction (for losses not connected with the trade or business if incurred in transactions entered into for profit) allowed by section 165(c)(2) shall be allowed, but only if the profit, if such transaction had resulted in a profit, would be included in gross income under this section.

'86 Code

(c) SPECIAL RULES OF SOURCE.—For purposes of subsection (b), the following items of gross income shall be treated as income from sources within the United States:

(1) SALE OF PROPERTY.—Gains on the sale or exchange of property (other than stock or debt obligations) located in the United States.

(2) STOCK OR DEBT OBLIGATIONS.—Gains on the sale or exchange of stock issued by a domestic corporation or debt obligations of United States persons or of the United States, a State or political subdivision thereof, or the District of Columbia.

For purposes of this section, gain on the sale or exchange of property which has a basis determined in whole or in part by reference to property described in paragraph (1) or (2) shall be treated as gain described in paragraph (1) or (2).

(d) EXCEPTION FOR LOSS OF CITIZENSHIP FOR CERTAIN CAUSES.—Subsection (a) shall not apply to a nonresident alien individual whose loss of United States citizenship resulted from the application of section 301(b), 350, or 355 of the Immigration and Nationality Act, as amended (8 U.S.C. 1401(b), 1482, or 1487).

(e) BURDEN OF PROOF.—If the Secretary establishes that it is reasonable to believe that an individual's loss of United States citizenship would, but for this section, result in a substantial reduction for the taxable year in the taxes on his probable income for such year, the burden of proving for such taxable year that such loss of citizenship did not have for one of its principal purposes the avoidance of taxes under this subtitle or subtitle B shall be on such individual.

Chairman JOHNSON. I thank the panel for your thoughtful testimony.

I have a number of questions, and I will start with Mr. Turner, at least I think I will start with Mr. Turner. I think I will have to come back to Mr. Turner. I am sorry, I can't find the notes I made on that.

Let me start with the other two panelists first, then. Both of you raised the issue of enforcement of current law. Why is it the administration can't tell me anything more about the numbers of people who have given up their citizenship in the last few years?

Can you tell me anything more about them in terms of their assets, or any information that might be relevant to whether this law is important and whether it will work and whether it will produce revenue? Why can't they tell me that?

Mr. NORMAN. I don't know for sure, but my educated guess would be that at the time that the people expatriate, they basically do it by going before a U.S. consulate outside the country. They do it before a consular officer and not before an IRS officer. There is really no coordination between the renunciation of citizenship, which is usually done by signing an oath outside the country and any IRS filing.

Chairman JOHNSON. What about these forms that you refer to that they would have the power to develop under the current law?

Mr. NORMAN. I would say that they have the power to require such forms.

Chairman JOHNSON. But they don't have forms currently. If they had had these forms, couldn't they give me a lot more information about who is renouncing and what their assets were?

Mr. NORMAN. Yes. What I am suggesting is that they require a statement. The statement would say I am renouncing and it would set forth the reasons why it is not for tax motivation, similar to what you do now, if you want to establish as an alien that you are not a resident alien. They also could have a balance sheet you must file if you say, I can't pay my taxes when due.

People file returns. They say, I just don't have the money. There is a special form where you set forth your balance sheet. The IRS could use that same concept and have a second page to this form so we would know who is expatriated. At the time they expatriate, we would know why or at least their statement as to why, and we would know what assets they have to determine if it is worthwhile auditing that particular case.

I think now they just don't know and they read it in Forbes or wherever, the Wall Street Journal. There is not an effective tie between the act of renouncing——

Chairman JOHNSON. In other words, they could have the information that we need to make rational policy and we don't have it because there has been no effort to implement the law and that is the conclusion I am drawing from your testimony, that they could have adopted regulations, they could have had forms, and if they had done those things, we would have a different——

Mr. NORMAN. I think they have the authority and the general regulatory power to issue regulations that would require these taxpayers to file a special form. We have a special permit when aliens

leave the country where they have to file a tax return in certain circumstances to leave the country.

I don't know why we couldn't have a similar procedure for citizens who expatriate. But again, I haven't worked for the IRS or Treasury, so I don't know the specifics of why they don't.

Chairman JOHNSON. Mr. Heller, do you have any comment?

Mr. HELLER. Well, I think it is significant to note that the IRS has a complete filing of stop-filers. These are people that are no longer filing tax returns.

Now, a lot of these are the result of the death of the taxpayer, but it would be appropriate, and I think I would suggest that one approach would be for the IRS to do a cross-check with the State Department of those stop-filers with those U.S. citizens who expatriate.

Chairman JOHNSON. Thank you.

Mr. Heller, in your statement you mention that disincentives to move to low-tax jurisdictions are understated by the Treasury. Could you enlarge on some of the disincentives to move to low-tax jurisdictions?

Mr. HELLER. Well, one of the major disincentives are the lack of adequate medical facilities. Many of the individuals that may expatriate and go back to their homeland behind the former Iron Curtain or go back to Cuba, these are older citizens. They don't want to be living in BVI or Turks and Caicos or the Bahamas. I don't know, you know, how often you have been down there, but I wouldn't want to get sick on one of those islands. In fact, we have documented cases where some of the wealthier people that did move down there have returned to other jurisdictions because of this real problem.

Chairman JOHNSON. All right. And also, both of you spoke about the need to look more carefully at how this change would affect other international agreements that we have. Could you give us more specific examples of problems that would be created by passage of this legislation for already negotiated tax treaties, how many would we have to renegotiate, how substantial would the issues be? How complex have those negotiations been in the past?

You know a lot more about this than I do. Give us some insight as to what passage of this kind of a provision would do to agreements already in place.

Mr. NORMAN. I think our best example is the negotiations we just concluded with Canada with respect to their protocol. They have a capital gains tax which is imposed when you give up residency in Canada or when you die. That is really a replacement for an estate tax. We have Canadians who are in the United States who would be subject to their capital gains tax and our estate tax. There would be no corresponding credit because one tax is an income tax and one tax is an estate tax and we don't allow crediting across those kinds of taxes.

Chairman JOHNSON. So those negotiations protect people from double taxation.

Mr. NORMAN. That is right. And the countries to be most important for these or those others that I can think of would be the United Kingdom, New Zealand, Canada, Australia, France, perhaps, Switzerland, and Germany. So there are a number of these coun-

tries, at least from my practice and from practitioners that I know in the area, where these issues would arise. So at least 10 or 15 treaties would be important. I think we have over 40 treaties, but not all of the countries would necessarily have a lot of these types of expatriates.

Chairman JOHNSON. I have some other questions, but I am going to yield at this time to my colleague, Mr. Hancock. I am pleased to welcome our colleague, Mr. Herger. I appreciate the attendance of my colleagues at this hearing.

Mr. HANCOCK. We have two witnesses that are actively practicing, in fact maybe all three of you are actively practicing tax law.

Mr. Turner, you are not a tax attorney; is that correct?

Mr. TURNER. That understates the case, sir. I know nothing about tax law.

Mr. HANCOCK. OK. Well, but the other two gentlemen are actively practicing.

Let me ask you this. But you are an expert on international law, Mr. Turner. Do you know of other governments that actually prohibit not the taxation, but prohibit the transfer of assets; in other words, that say OK, you can leave the country, but you can't take anything with you.

Mr. TURNER. I don't know. My primary area is public international law, and what you are talking about is comparative law or internal foreign law, and I really haven't looked at that at all.

Mr. HANCOCK. Let me ask Mr. Heller and Mr. Norman. Is this true some countries, especially the Third World countries, prohibit removal or the moving of assets in and out of the country, is that not correct? In fact, hasn't that been one of the problems down in Mexico?

Mr. NORMAN. That was one of the problems in Mexico. South Africa had exchange controls. Exchange controls are now coming off in many, many countries. In most of the countries that we have trade relationships, we don't have really significant exchange control, but in many of the less developed countries they do exist.

Mr. HANCOCK. But historically in your judgment, is the restrictions upon the free flow of funds one of the things that has kept those countries in the economic condition they are in because nobody wants to go in and invest in a country when they can't get their money out of the country?

Mr. NORMAN. Well, clearly, that is one of the first things we talked about when a U.S. company or a U.S. individual considers investing in a foreign country, that is the very first question we talk about. First the tax treatment and then, can we repatriate our profits if we make money or even get our money out of the country if we sell it out.

Mr. HANCOCK. OK. Would this bill that has been introduced by the administration create a little bit of that question in an individual's mind when there is talk about investing or coming in or making his money here in the United States if he knew he could be subjected to this tax ahead of time? Would you agree with that statement?

Mr. NORMAN. It is going to be perceived as an exit tax, and I think it is mostly high net worth individuals who are going to look at this tax and say I don't want to get in this system because I

can't get out without having these deemed sales which is going to cause some of the cash flow problems that Mr. Heller talked about as well as the tax.

So it is going to be a barrier. It is going to be talked about, as I said, in newspapers and business magazines; it is going to be in tax seminars. This is going to become a major topic of discussion when somebody thinks about investing in the United States. It is going to be a negative.

Mr. HELLER. And I might add if I may that when you are sitting down with a client from a foreign country, inevitably that is one of the questions that comes up, will there be any restrictions on the free flow of funds. And many of these individuals have had very negative experiences with other countries.

Mr. HANCOCK. This is just now beginning to get a little publicity, I heard about it a few years ago, you know, that there were certain people that were not only considering expatriating, moving their citizenship, but also moving their assets to offshore tax shelters. It has been going on for a long time. We have all heard the stories about the secret bank accounts in Switzerland and what have you.

In the past few years, in your practice, and I know there are a lot of wealthy individuals out along that golden shoreline over there where you are from, the Los Angeles area.

Is the publicity on this issue starting to cause people to call you and say, hey—you have a lot of people that live out there that are worth $25 million, $50 million, which is a lot of money, but not all that much—30 years ago it was a lot of money.

Are you getting more inquiry in this area?

Mr. NORMAN. I think what I am saying is, we have more of what I call multinational families. We have families where all of the members are not citizens or residents of a single country. We have Taiwanese, Hong Kong, Indonesian, Philippine people coming into the United States. Their parents may stay back in the home country, the children may not all come to the United States, some may go to Canada, some may go to the United Kingdom, and those people are concerned about these kinds of measures and also the measures that were in the broader administration proposal dealing with foreign trust.

In terms of the people worried about moving assets offshore, some people are worried about tort liability and using foreign trusts as asset protection devices. There is no tax advantage to that; it is more protection from future creditors. You do see that.

In terms of persons worried about capital gains taxes, every year in my practice, and there is probably a half a dozen or so of us on the West Coast that have some reputation in advising in this area, every year or so I get a half a dozen or so people who are either worried about capital gains or worried about estate tax. Very few of them, once you get the whole picture out in front of them, are interested in expatriation, because it requires a major change in lifestyle, problems with—I even had a 92-year-old woman whose children thought it was crazy that she was thinking about it. She never did it. It is just not practical.

It is an estate tax avoidance device for most people. Capital gains taxes, people were concerned when tax rates started creeping up after the 1986 act, and there is interest in that area, and there are

a few, to take the Treasury's word, there are 24 people, there are a few, some on the West Coast who are concerned about the capital gains tax. But if that rate was reduced, I don't think the interest would be there.

Mr. HANCOCK. I would just like to make one comment. Almost ever since I have been an observer of what is going on in this country, after getting out of school, also especially since I have been here in the U.S. Congress and the rhetoric that I have been hearing up here, especially right now, is you have to be in favor of taxing the rich if you are going to be politically correct.

That theory of taxing the rich started about 100 or so years ago with a socialistic concept, and the redistribution of the wealth, and it would appear to me, and I am just going to make a statement, and I won't ask for you to make a comment, it would appear to me that this is another move on the part of certain people to get back to that theory, well, they are not entitled to accumulate all of this big money, they had to be dishonest or something, they didn't provide a service or anything else. But anyway, with that, thank you, Madam Chairman.

Chairman JOHNSON. Mr. Herger.

Mr. HERGER. Thank you very much, Madam Chair. Just a follow-up on that line of questioning.

We would like to think that here in America, that the ideal is that people could work hard, be entrepreneurs, work hard in their business and profession and do well and hopefully not be taxed out of everything they have if they happen to reach that point. But I would like to think back to several years ago, when the members of that other party were controlling both the House and the Senate, we had, in this same vein, the luxury tax.

We were really going to sock it to those people who acquired anything that was a "luxury," and you can see what we did to the yacht business. We basically destroyed the yacht business. People did not continue buying yachts with the high taxes. We saw industry basically go out of business over a couple years before we finally repealed that. People just didn't buy them. We had people on welfare then who were paying taxes prior to that.

But I guess in this line, I am just interested, Mr. Heller, what your advice would be to your clients who are either renouncing their citizenship, and I might ask that first question, what would be your advice to a—someone who is currently a citizen who would be considering renouncing their citizenship to go to maybe the land they emigrated from, for example, if this tax bill were to go through.

Mr. HELLER. Well, if this tax bill went through and I was advising an individual who was considering expatriating and moving back to their foreign homeland, say Czechoslovakia or Hungary, I would have to advise them what the tax consequences would be, and we would have to sit down and actually evaluate their assets, do something that we wouldn't have to do now because the problem is they may want to leave the country or give up their citizenship, but they want to—they may want to continue owning the business, and if they continue owning the closely held business, then we will, as U.S.—the government will continue to collect taxes from this business.

If, on the other hand, they are required to liquidate the business in order to pay the taxes, then everybody is a loser. They are a loser and we are the loser, and the question really is, you know, does this discourage or encourage somebody to do this by imposing this exit tax. I suggest that it isn't the proper approach.

The proper approach is to work within the current system, within the current statute, and allow these people to pay their taxes when there is a realization event, when they sell those properties, and we can put in the necessary checks and balances and do some of the administrative things, working with the existing statute.

Mr. HERGER. Now, if these individuals are paying the same amount of tax—well, they are currently citizens so, therefore, they are paying the same tax as everyone else. Let's maybe look on the other side of the coin somewhat. Let's say there is an immigrant that is considering coming to this country, considering—here is someone with business skills, someone who is a professional person, someone who theoretically is going to be adding to our society here, like so many of the immigrants.

My grandparents, two of my four grandparents were immigrants to this country. My father didn't know any English when he started school. That was common in those days. It is not an uncommon thing today, nor was it then, nor was it since our country was founded, but let's say those immigrants who are considering coming here, what would be your—would you have recommendations to them that would be any different were this legislation to go through than what it would be now?

And Mr. Norman, if either one of you have a comment.

Mr. NORMAN. Clearly what you would have to say if these are high net worth individuals you have got to think twice about getting into our system, depending on the scope of the proposal. If it covers only citizens, then you are only worried about those individuals who convert or become U.S. citizens, because only those taxpayers would be subject to tax if they later returned to their home country. But if you are talking about—if the scope of the provisions would cover long-term residents, we are going to advise against long-term residents, if taxes mean anything to them.

And at this point, when somebody is just considering immigrating to the United States, they are in a decisionmaking mode. They have a choice of coming to the United States and being stuck in a tax system that doesn't allow them make a second choice, so to speak, to reevaluate whether they really want to be long-term residents or not, for other reasons, which may or may not be tax motivated. They have Canada which is very friendly toward new immigrants, gives them a new tax basis at the date they become a resident, allows them to set up trusts, preimmigration trusts that will not end up subjecting them to the tax for 5 years if they change their mind, as many Hong Kong people have.

They come to Canada, they stay there 3 years, get their citizenship, which is what they want because they are uncertain about the status of Hong Kong, and now they have a Canadian citizenship and they can give up their residency and Canada has not imposed a tax. And those are the places they are going to go, and they are going to Australia.

Even if they have exit taxes, which the Treasury has pointed out or the Joint Committee in some of their testimony, they are very friendly toward immigrants. This provision is, at least in the original version of it, is not for only the long-term immigrants, the long-term residents that remain aliens, and it clearly is not for those who become citizens.

Often these people retain dual citizenship and at some later date, at retirement, upon a change of circumstance at home, a change in opportunities at home, political changes at home, they don't have to be as radical as from communism to noncommunism, just political changes, they will go back home. It is certainly convenient for them to just be a citizen of one country, and they often do that, and it is not because they are traitors to our country. They really have a dual loyalty from the beginning and they are just making a choice.

And I think you are going to have a lot of these people not wanting to come here and clearly not staying here a long time and certainly not converting or becoming a citizen.

That is going to be on every immigration lawyer's checklist, the tax consequences of becoming a citizen. That you are in the system and you can never make a second choice, you can't go back to Switzerland, you can't go back to Israel or Hong Kong or wherever it is. You are in it, and that could be a big thing, because these people are not only concerned about their own wealth, but passing wealth on to their children, giving their children a good start in life, and if they have a big family, $600,000 of appreciation doesn't go a long way especially if you have a really big family like some of these immigrants do.

Mr. HERGER. Well, thank you very much. And again, as I reflect back on my heritage, I think of the greatness of this country as really the freedom of choice. And what I am concerned about with this type of legislation is that we are taking away many of the freedoms because of what penalties are being inflicted on those who could contribute to our society, and I think we should all not take this action lightly. We should consider it, should consider the dynamics.

I thank you for your testimony here today. Thank you.

Chairman JOHNSON. I have just two more questions that I want to ask. Is it possible for two people who have similar histories of earning and assets to be taxed differently under this law?

Mr. NORMAN. This law taxes two things. It taxes people who make a choice—practically, we are talking about dual citizens because nobody is going to give up their U.S. citizenship if they have no other citizenship. So it taxes that and it also taxes—in fact only imposes taxes if you have appreciation that rises to some threshold level.

So you could have persons who have high income potential, are making a lot of money but have been spending it or not investing in ways that have created appreciation and those people slip right through the proposed new system if you will.

Chairman JOHNSON. So this doesn't treat all people the same according to income. This isn't a tax on their net worth, this is only a tax on their gain.

Mr. NORMAN. A tax on their built-in gain.

Chairman JOHNSON. So two people could have exactly the same asset profile and not be subject to the same tax.

Mr. NORMAN. If you inherited, say, $5 million, you would get a new stepped-up basis. If that person wanted to expatriate under this provision, they wouldn't be taxed. If the same person had $5 million in assets and it represented the buildup in the value of a business over time, then that appreciation would be taxed.

Chairman JOHNSON. I think that is very important to recognize. This isn't about just rich-poor. This is really actually not even about equity. This is about looking at a very specific type of gain and going after that specific type of gain, and this will not prevent people who have high value assets in this country or high income from not escaping if they care to, as long as they don't have a net gain.

Mr. NORMAN. I have had situations where people, because of the recession in the real estate market or because of stock market changes where they might have had a very huge total net worth, I mean, relatively huge in my view, say $10 or $15 million, they now have no net appreciation or very little net appreciation.

Chairman JOHNSON. So what you might advise a client is, where you have a big loss impending in some part of your portfolio and when it offsets it, you can change your citizenship or renounce your citizenship without any tax consequences, but if your portfolio does well, don't renounce.

Mr. NORMAN. What is going to happen is you are going to have new planning techniques. If you are going to make a lot of money in the future, get out now, or if you have, as you suggested, you have losses that offset gains, now is the time to expatriate. I don't think we want those kinds of incentives in the law.

Chairman JOHNSON. One last question to Mr. Turner.

You know, Mr. Turner, you really pointed out some very powerful phrases in legislation and in international agreements to which we are a party that make it very, very clear that we have taken the position that people have a right to citizenship and have a right to change their citizenship, and I thought the portion that you pointed out from section 2432 of freedom of immigration, East-West trade that says that no country shall have the right to impose more than a nominal tax on immigration or on the visas or other documents required for immigration for any purpose or cause whatsoever or, and it goes on to say, impose more than a nominal tax, levy, fine, fee on any charge on any citizen as a consequence of the desire of such citizen to immigrate to the country of his choice, was very powerful.

And when you put that up against the assumptions behind both Joint Tax's estimates and the Treasury's estimates, because we just had testimony from Treasury that they thought their assumptions were the same as Joint Tax's assumptions. Joint Tax's assumptions are that this levy will be significant enough that people will decide not to change their citizenship, not to relinquish their citizenship and we get the money because they continue to pay what they are currently paying.

Now, a fee that is so powerful that it would lead you to not relinquish, when you had desired to relinquish, seems to me in very direct contradiction of the laws and agreements that you have called

to our attention. Do you think the assumptions behind their estimates do call into question our commitment under these treaties?

Mr. TURNER. Madam Chairman, I think it raises a very serious problem. I think the United States has led the world in some respects in this area, in the right of citizens not just to travel, not just to spend a weekend in the Holy Land, but to actually pick up and renounce their citizenship in one State, move to another State, settle there permanently and pledge allegiance to that State, I think one can argue technically that perhaps you can get around the language of the covenant.

I think the covenant is arguable one way or the other; but having spent an awful lot of time working on the Jackson-Vanik amendment, I really have a lot of trouble trying to get around that. It is very strong language—"for any purpose or cause whatsoever,"—and again, I can say from my own recollection, having worked on it 21 years ago, it is my strong sense that Scoop Jackson and the other people involved in this were talking about affirming the right, especially of Soviet Jews, but of anyone in the Soviet Union, to renounce that citizenship relationship, to move free of molestation to another State, and to set up a new life there and be totally free of any further control by the Soviet Union.

If we had said, well, yes, they have the right to travel, but they don't have a right to give up their citizenship, then in theory the Soviets could have required them to return for military service, or for taxes, or for a variety of other purposes in the years that followed. One of the problems we had in this country that so upset Jefferson, and led Congress to pass the statute I quoted back in 1868, was if someone came to the United States and established American citizenship and then traveled back to Ireland—which then denied this right to renounce citizenship, this right of expatriation—then the Irish Government could harass that person and say, you owe us taxes, or you owe us military service, or you owe us some other obligation that the U.S. Government has historically said was not within their rights under international law to claim.

You are going to hear from Paul Stephan, who is a very able scholar, a very bright man, and he is going to disagree strongly with me—and he may well be right. Professor Detlev Vagts, I gather, has submitted a letter. I talked to Professor Lou Henken, a very distinguished scholar at Columbia University, who told me he didn't see a problem here.

It may be because I have only had a few days to look at this that I have been misled, but it strikes me the values at stake are so important and, relatively speaking, the money we are talking about here is almost trivial. I know $1 billion is a lot of money, but in terms of human rights values that this country has stood for since the days of Thomas Jefferson, $1 or $2 billion toward the deficit is not worth sacrificing one iota of human rights in my view.

Chairman JOHNSON. I very much appreciate your being able to testify and, as you pointed out, on very short notice, but these are big enough issues, and underlying this proposal are some very big issues, both in terms of our historic commitment to human rights of our international obligations, of the concept of equitable treatment, of taxpayers in similar circumstances, and what kinds of incentives are we going to create for investors in our economy that

even on short notice, this is worth the kind of attention that we are giving it today and that I hope we will give it in the months ahead.

I would conclude this panel that one of the things that you have brought out that has been very useful to us is that this would create new and perverse incentives for people to relinquish their citizenship before they hit the threshold if they were likely to hit it, and want to move. So it would precipitate that decision early which means that we wouldn't get the money nor the penalty, neither one, and in not many years, that would all come to pass.

Unless the Members have more questions of this panel, we will move to the next one. Thank you very much for your testimony.

The next panel consists of Stephen Shay of Boston, Massachusetts; Paul Stephan, professor at the University of Virginia Law School; Carlyn McCaffrey, New York; and Rabbi Jack Moline, vice president of the Washington Board of Rabbis.

We will start with Stephen Shay.

Mr. Shay.

STATEMENT OF STEPHEN E. SHAY, ESQ., PARTNER, ROPES & GRAY, BOSTON, MASSACHUSETTS; AND FORMER INTERNATIONAL TAX COUNSEL, U.S. DEPARTMENT OF THE TREASURY

Mr. SHAY. Thank you, Madam Chair. Thank you and other Members of the Subcommittee for inviting me to testify today regarding the administration's proposal. I would like to submit my statement for the record.

I am a partner in the law firm of Ropes & Gray in Boston where I practice international tax law on behalf of U.S. and non-U.S. corporate and individual clients. Prior to joining Ropes & Gray in 1987, I served as International Tax Counsel to the U.S. Treasury during the Reagan administration.

I am testifying today in an individual capacity. My comments are not made as a representative of my law firm, its clients, or of any bar or professional associations of which I am a member.

I have submitted detailed comments that I don't propose to summarize here. Subject to some technical modifications in those comments, I strongly support the administration proposal. I think it is helpful to keep this simple. The United States taxes citizens and residents on their worldwide income. We tax nonresidents only on U.S. source income.

I think it is appropriate for the United States to tax appreciated assets at the time that a citizen or resident moves from full taxing jurisdiction to partial taxing jurisdiction for reasons I will describe very briefly. This is a vast improvement over current law because it accurately measures, and imposes U.S. tax on the appreciation that has accrued during the time a taxpayer is subject to full U.S. taxation jurisdiction. I express this view without any regard to the issue of tax motivation.

You can think of it most simply in terms of you and your neighbor. Assume that both of us work very hard and at the point in time where we are each fortunate enough to have assets that have appreciated over $600,000, one of us leaves the country and renounces citizenship, or if that person is a long-term resident, for

whatever reason he took up residence in the United States, after having been here in excess of 10 years under the administration's proposal, leaves in a situation where, after leaving, he sells that asset and recognizes the gain without U.S. tax.

In my view, the gain that has accrued up to the point of departure is an appropriate gain to be subject to U.S. taxing jurisdiction. Moreover, I, as a person who is here, or perhaps it is you or your colleague, cannot sell that asset without being subject to full capital gains tax at whatever rate it happens to be. I have made all of my remarks and testimony on the basis of current law, without expressing perhaps a hoped-for view that the law might change in one direction or another.

I think, Madam Chair, this is an issue of equity. The fact is that section 877 today is laughably avoidable. A well-advised expatriate should not pay U.S. tax whether he is renouncing his citizenship or if a long-term resident, ceasing to be a resident, on assets not disposed of before he leaves.

There are a series of technical problems with section 877 under today's law, one of which I will mention. Because that section applies in those rare cases where a principal purpose to avoid tax is found, and I say that is rare because of the case law under that section which I have cited in my testimony, it will tax appreciation after the person has left. In my view, the section taxes too much in that case. That is why I favor the administration proposal as taxing the right amount when tax is indeed due.

I think I would like to make one last personal comment which is not in my testimony. I am no expert on human rights but I have evaluated my views on this provision by a very simple test. My wife, 8-year-old son and 4-year-old daughter are Jewish. I have asked myself, should they decide to expatriate to go to Israel later in our lives, would I feel it appropriate to pay tax on the gains that I have been fortunate enough to realize as a citizen of the United States up until the time we leave, and my unquestioning answer, Madam Chair, is yes.

Thank you.

[The prepared statement follows:]

PREPARED STATEMENT OF
STEPHEN E. SHAY
BEFORE
SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

MARCH 27, 1995

Madame Chairman, Members of the Subcommittee:

Thank you for inviting me to testify today regarding the Administration's proposals to impose a tax on U.S. citizens who renounce their citizenship and long-term resident aliens who cease to be subject to tax as residents.[1]

I am a partner in the law firm Ropes & Gray in Boston, where I practice international tax law on behalf of U.S. and non-U.S. corporate and individual clients. Prior to joining Ropes & Gray, I served as International Tax Counsel to the U.S. Treasury Department.

I am testifying today in an individual capacity. My comments are not made as a representative of Ropes & Gray or any of its clients, or of any of the other bar or professional associations of which I am a member.

Subject to certain technical comments discussed below, I strongly support the Administration's proposal. It is appropriate for the United States to tax appreciated assets at the time a U.S. citizen or resident moves from full U.S. personal taxation jurisdiction to being subject solely to U.S. source taxation. The proposal is an improvement over current law because it more accurately measures and imposes U.S. taxes on appreciation that accrues while a taxpayer is subject to full U.S. personal taxation jurisdiction.

Description of Current Law

The United States exercises personal jurisdiction to tax individuals by taxing the worldwide income of U.S. citizens (whether or not resident or domiciled in the United States) and residents.[2] A U.S. taxpayer may elect to credit foreign income taxes against his U.S. tax, subject to a limitation that applies with respect to categories of foreign source income to restrict the credit to the amount of U.S. tax paid with respect to income in that category.

The United States asserts a source-based tax on nonresident aliens.[3] Nonresident aliens are taxed on the gross amount of U.S.-source interest, dividends, rents, and other fixed or determinable income at a flat rate of 30 percent (or a lower treaty rate). This tax generally is collected by withholding. A nonresident alien is taxed at regular graduated rates on income that is effectively connected with a U.S. trade or business, less deductions that are properly allocable

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[1] I wish to thank my colleague, Debra Brown Allen, Esq., for her assistance in preparing this testimony.

[2] Taxation on the basis of citizenship is different from the practice of most countries, which is to tax individuals on the basis of residence. The Supreme Court, however, has upheld the constitutionality of taxing a nonresident citizen. *Cook v. Tait*, 265 U.S. 47 (1924).

[3] A nonresident alien individual is an individual who is neither a U.S. citizen nor a resident alien. Generally, an alien individual is a resident alien for U.S. tax purposes under Section 7701(b) if he or she (1) is a lawful permanent resident of the United States (i.e., holds a green card), or (2) satisfies the "substantial presence" test as a result of being physically present in the United States for a prescribed amount of time.

to the effectively connected income. A nonresident alien individual is allowed a foreign tax credit under Section 906[4] only for foreign taxes paid with respect to income effectively connected with a U.S. trade or business.

Under current law, the only income tax provision governing a change from citizenship to non-citizenship status is Section 877, first enacted in 1966. Under Section 877, a special taxation regime applies to a U.S. citizen who relinquishes his U.S. citizenship with a principal purpose of avoiding Federal income tax. Such an individual may be taxed either as a nonresident alien or under an alternative taxing method, whichever yields the greater tax, for 10 years after expatriation. For purposes of determining the tax under the alternative method, gains on the sale of property located in the United States and stocks and securities issued by U.S. persons are treated as U.S.-source income, taxable at rates applicable to U.S. citizens.

Whether tax avoidance is a principal purpose for the expatriation is determined by all of the relevant facts and circumstances. If the I.R.S. establishes that it is reasonable to believe that the loss of U.S. citizenship would result in a substantial reduction in the taxpayer's income taxes for the year (taking account of U.S. and foreign taxes),[5] then the burden of proving that the loss of citizenship did not have tax avoidance as one of its principal purposes shifts to the taxpayer.[6]

The taxing rules of Section 877(b) (which does not include the principal purpose test) are applied under Section 7701(b)(10) in the case of a resident alien individual who is resident in the United States for three consecutive years, then ceases to be a resident, and subsequently becomes a resident before the end of the third calendar year beginning after the close of the initial residency period. This anti-abuse rule protects the U.S. tax base from erosion by a resident alien who transfers residence from the United States for a limited period of time in order to sell an appreciated asset and then resumes his or her U.S. residence.

Deficiencies of Current Law

Section 877 was enacted in 1966 as part of the Foreign Investors Tax Act, which was intended to spur foreign investment in the United States by eliminating graduated rates with respect to non-effectively connected income of a nonresident alien. Section 877 was adopted because Congress was concerned that this rule could encourage some individuals to surrender their U.S. citizenship and move abroad.[7] The 89th Congress did not have any experience as to whether the other changes in taxation of nonresident aliens made by the Foreign Investors Tax Act would induce expatriations and chose to employ a tax avoidance purpose condition to the application of Section 877.

Section 877 has several weaknesses, both on its own and as a function of its interplay with other aspects of the U.S. tax scheme. The weaknesses include: (1) Section 877 is triggered only if the expatriate had tax avoidance as a principal purpose; (2) tax treaties with other countries may prevent the United States from taxing nonresidents, even with the existence of Section 877; (3) Section 877, by deferring tax until the expatriate sells his assets, generally does not properly tax the gain (or loss) that accrued while the taxpayer was a U.S. citizen; (4) the interplay of Section 877, Section 906 and tax treaties with other countries may result in

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[4] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended and as proposed to be amended by the Committee Bill.

[5] *See Enrico di Portanova v. United States*, 690 F.2d 169, 176 (Ct. Cl. 1982) (citing H.R. Rep. No. 1480, 89th Cong., 2d Sess. 82, reprinted in 1966-2 C.B. 965, 1025).

[6] The presumption of tax avoidance is rebuttable. *See, e.g., Furstenberg v. Commissioner*, 83 T.C. 755 (1984).

[7] H.R. Rep. No. 1450, 89th Cong., 2nd Sess. 22 (1966).

inappropriate double taxation; and (5) Section 877 easily may be avoided by holding assets for more than ten years or converting U.S. income and assets into foreign income and assets. Although Section 7701(b)(10) does not require proof of a principal purpose of tax avoidance, it is otherwise subject to the same infirmities as Section 877.

The facts of the *Furstenberg* case, in which the Tax Court found that the taxpayer's expatriation did not have tax avoidance as a principal purpose, illustrate why a tax avoidance purpose standard is ill-advised. To satisfy a commitment made before her marriage to her new husband, Mrs. Furstenberg renounced her U.S. citizenship immediately after her honeymoon on December 23, 1975. As a result of the Tax Court's decision that Section 877 did not apply, it appears that Mrs. Furstenberg paid no U.S. tax on as much as $9.8 million of capital gains from selling securities owned at the time of her expatriation in the two years following her expatriation.

There is ample precedent for asserting a tax on appreciated assets at a time when the asset will no longer be subject to U.S. personal taxing jurisdiction. Under Sections 367 and 1491, the United States overrides otherwise applicable nonrecognition rules in order to tax transfers of appreciated assets to foreign entities. It is accepted that this principle should apply in circumstances where there is no actual transfer of an asset, for example, when a foreign trust ceases to be a grantor trust with a U.S. grantor.[8] Amendments in 1984 to Sections 367 and 1492 deleted exceptions to taxation of such outbound transfers where the taxpayer could establish that the transfer did not have as one of its principal purposes the avoidance of Federal income taxes. Because a principal purpose test is difficult to administer and subject to abuse, it similarly should be deleted from Section 877.[9]

Another difficulty with both current Section 877 and Section 7701(b)(10) is that the United States may be unable to collect taxes due under the terms of these sections because of treaty provisions. Although the so-called savings clause found in most modern income tax treaties generally provides that the United States may tax its citizens and residents as though the treaty had not come into effect[10] and the I.R.S. has published a revenue ruling taking the position that the savings clause preserved U.S. taxation of former citizens taxable under Section 877,[11] the Tax Court held in *Crow v. Commissioner*, 85 T.C. 376 (1985), that the savings clause of the 1942 United States - Canada Income Tax Convention did not apply to a former citizen who, it was assumed for purposes of deciding petitioner's motion for summary judgment, expatriated to Canada for a principal purpose of avoiding U.S. tax. The Court found that, properly interpreted, the Convention prohibited the United States from taxing the taxpayer's capital gain from the sale of stock under Section 877. Based on the *Crow* decision, it is doubtful whether the United

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[8] Rev. Rul. 87-61, 1987-2 C.B. 219.

[9] There are a series of exceptions to taxation at the time of transfer under Sections 367 and 1491 that are based in substantial part on the fact that the transferring shareholder remains subject to residence-based taxation on property that receives a carryover basis in the exchange for the transferred property. That circumstance is not present in the context of Section 877.

[10] See U.S. Department of the Treasury, Proposed Model Convention Between the United States and _____ for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion, Art. 1(3) (1981), reprinted in 1 Tax Treaties (CCH) ¶ 208 (1994) (hereinafter "U.S. Model Treaty"). The savings clause implements the U.S. policy that tax treaties generally are not intended to affect U.S. taxation of U.S. citizens or residents. American Law Institute, *Federal Income Tax Project: International Aspects of United States Income Taxation (Proposals of the American Law Institute on United States Income Tax Treaties)*, 229 N. 606 (1992).

[11] Rev. Rul. 79-152, 1979-1 C.B. 237 (holding that a liquidating distribution would be taxable to a Section 877 expatriate that acquired residence in a treaty country even though the treaty did not preserve U.S. right to tax under Section 877).

States may tax a treaty resident under Section 877 on income that a treaty reserves for taxation by the country of residence unless the treaty specifically preserves the U.S. right to tax a Section 877 expatriate.

Current U.S. treaty policy is to cover Section 877 expatriates under the savings clause to permit the United States to tax income or gains of a Section 877 expatriate who is resident in the treaty partner country notwithstanding other articles of the treaty.[12] However, even where the savings clause covers taxation of an expatriate under Section 877, the coverage may be less than complete.[13]

If a nonresident alien otherwise subject to Section 7701(b)(10) were resident in a treaty country for purposes of an income tax treaty between the United States and that country, the treaty would apply to the nonresident without regard to the savings clause. Most (but not all) U.S. income tax treaties would prohibit U.S. taxation of such a treaty resident's gains from the sale of property other than real estate or assets connected with a U.S. trade or business.

Perhaps the most significant objection to current law Sections 877 and 7701(b)(10) is that they rarely, if ever, will measure correctly, and thus tax, gains that accrued while the taxpayer subject to a Section 877 tax was a U.S. citizen or resident. This is because Sections 877 and 7701(b)(10) defer U.S. taxation, imposing such tax on gains realized within a ten or three-year expatriation period. Sections 877 and 7701(b)(10) therefore may result in either over-taxation or under-taxation, depending upon whether the asset appreciates or depreciates in value between the time of expatriation and the time of sale or disposition. For example, if a U.S. citizen expatriates with a tax avoidance motive and, seven years later, sells an asset, Section 877 would subject the entire gain from the sale to U.S. taxation, including any gain that accrued post-expatriation. Similarly, under Section 7701(b)(10), if a resident alien ceases to be treated as a resident, sells an asset two years later and subsequently returns to the United States, he will be taxed on the full gain from the sale, including any gains that accrued during the two years in which he was not a U.S. resident. These post-expatriation gains (or gains accruing during a period of non-residency), should not be subject to U.S. tax. Conversely, under both Section 877 and Section 7701(b)(10), if the taxpayer's assets declined in value during either post-expatriation or the taxpayer's period of non-residency, the United States would not capture all of the gains that had accrued during citizenship or residency, which, arguably, should be subject to U.S. tax. A tax imposed at the time of expatriation, however, would accurately delineate gains properly subject to U.S. taxing jurisdiction.

The current taxation scheme under Section 877 may result in double taxation. A foreign tax credit is not allowed for foreign taxes on income that is deemed to be U.S.-source income under the alternative method. Section 877(c) transforms foreign income that would not be effectively connected income into U.S.-source gross income, but does not cause the income to be effectively connected income. The Section 906 foreign tax credit therefore does not allow a credit for any foreign tax that may be imposed on the re-sourced income (assuming that the taxpayer had sufficient foreign tax credit limitation to credit the tax).

It does not appear that treaties remedy the failure of the domestic law foreign tax credit mechanism to avoid double taxation for expatriating citizens under Section 877, even where the gain accrues after the taxpayer's expatriation. For example, the 1980 Convention between the United States and Canada allows the United States to impose tax on gains from the sale of stock

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[12] See U.S. Model Treaty, Art. 1(3).

[13] The 1993 U.S. treaty with the Netherlands, for example, does not cover Section 877 expatriates who are Dutch nationals. Convention Between the United States of America and The Kingdom of the Netherlands for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income, Art. 24(1).

in a U.S. company realized by a Section 877 expatriate who is resident in Canada.[14] Canada also would be allowed to tax the gains.[15] For purposes of applying the foreign tax credit provisions of the Convention, the gains from the sale of stock would be treated as Canadian-source income,[16] however, the United States does not commit to allow a credit for the Canadian tax.[17]

Yet another problem with current Sections 877 and 7701(b)(10) is that they are easily avoided. Residents who cease to be treated as residents and sell appreciated assets during the period of non-residency can avoid Section 7701(b)(10) merely be extending their period of non-residency beyond the three-year period. Section 877 may be avoided as easily. I quote from a 1993 article published in Tax Notes International:

> "Even for those nonresident former U.S. citizens with substantial U.S. assets and income, there are techniques that can greatly reduce the impact of the anti-abuse rules by converting U.S. income and assets into foreign income and assets or by deferring income and taxable transfers until after the 10-year period under the anti-abuse rules has expired.
>
> For example, consider the plight of a tax-motivated former U.S. citizen living abroad and owning a portfolio of U.S. stocks and bonds. Without taking any measures, such a person would be subject to U.S. income tax on interest, dividends and capital gain from the portfolio and would be subject to a U.S. estate and gift tax on taxable transfers of assets in the portfolio. Such an individual could, however, transfer the portfolio to a foreign corporation that is not engaged in a U.S. trade or business with drastically more favorable results.
>
> For income tax purposes, the foreign corporation would itself be taxed in the same manner as an NRA who had never been a U.S. citizen (i.e., gross U.S.-source dividends would be subject to a flat 30- percent-or-lower withholding tax, certain types of U.S.-source interest would be subject to a similar flat withholding tax while other types of U.S.-source interest would be exempt under the portfolio interest or other exemptions and capital gains would be exempt from tax unless real estate related). While a sale of stock in the foreign corporation by the former U.S. citizen would be treated as taxable U.S.-source income under the anti-abuse rule, a sale of the U.S. stocks and securities in the portfolio by the foreign corporation would not. Moreover, dividends by the foreign corporation to its shareholders would be foreign-source, and therefore free from U.S. tax, even if the foreign corporation's earnings out of which it pays the dividends are U.S.-source interest, dividends, and capital gains." (Footnotes omitted.)[18]

In light of the increasing sophistication of taxpayers, it is not surprising that the easy pickings of tax-motivated expatriation are too tempting for some to resist. Based on informal discussions with the State Department, the Staff of the Joint Committee on Taxation has reported that 697 citizens expatriated in 1993 and 858 in 1994.[19] There is evidence that some of these

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[14] Convention Between the United States of America and Canada With Respect to Taxes on Income and on Capital ("U.S. - Canada Treaty"), Art. XXIX(2).

[15] U.S. - Canada Treaty, Art. XIII(4).

[16] U.S. - Canada Treaty, Art. XXIV(3)(b).

[17] *See* U.S. - Canada Treaty, Art. XXIV(1).

[18] Zimble, *"Expatriate Games: The U.S. Taxation of Former Citizens,"* Tax Notes Int'l (Nov. 2, 1993), LEXIS 93 TNI 211-15.

[19] Staff of the Joint Committee on Taxation, *"Description of Revenue Provisions Contained in the President's Fiscal Year 1996 Budget Proposal,"* Footnote 6 (JCS-5-95, Feb. 15,

expatriations will result in substantial revenue loss as a result of the infirmities of current Section 877. It is time to amend the law to address current realities.

Description of the Administration's Proposal and Modifications Made by H.R. 831 as Reported by the Senate Finance Committee

Under the Administration's Proposal, a U.S. citizen who relinquishes U.S. citizenship or a long-term resident who ceases to be subject to tax as a resident generally would be treated as having sold all of his or her property at fair market value immediately prior to relinquishing citizenship or ceasing to be subject to tax as a resident (the "expatriation date") and gain or loss from the deemed sale would be subject to U.S. income tax. In addition, the deferral of tax or income recognition (e.g., due to the installment method) would terminate on the date of the deemed sale and the deferred tax would be due and payable on that date. The first $600,000 of net gain recognized on the deemed sale would be exempt from tax. Under the Administration's Proposal, a long-term resident is any individual who is not a U.S. citizen and who is subject to tax as a resident, as a result of being a lawful permanent resident of the United States, for 10 of the last 15 years. A citizen would be treated as relinquishing citizenship on the date the Department of State issues to the individual a certificate of loss of nationality or the date a U.S. court cancels a naturalized citizen's certificate of naturalization.

Generally, property interests that would be included in the individual's gross estate under the Federal estate tax if such individual were to die on the day of the deemed sale, plus trust interests that are attributed to the taxpayer under expanded attribution rules, would be taxed on the expatriation date. A long-term resident would be allowed to elect to take a fair market value basis in property owned on the date the individual first became a resident for purposes of the period of long-term residency and treated as sold on the expatriation date.

U.S. real property interests, which remain subject to U.S. taxing jurisdiction in the hands of nonresident aliens, generally would be excepted from the proposal.[20] Certain interests in qualified retirement plans and, subject to a limit of $ 500,000, interests in foreign pension plans (as provided in regulations) also would be excepted from the deemed sale rule. The I.R.S. would be authorized to reach an agreement with a taxpayer to defer payment of the tax on an interest in a closely-held business (as defined in Section 6166(b)) for up to five years.

The Administration Proposal would be effective for U.S. citizens who relinquish their U.S. citizenship on or after February 6, 1995 and long-term residents who cease to be subject to tax as residents of the United States on or after that date.

The version of H.R. 831 reported by the Senate Finance Committee (the "Senate Finance Bill") only would have applied to expatriating citizens, but included several significant modifications to the Administration Proposal. Under the Senate Finance Bill, a U.S. citizen would be treated as having relinquished his citizenship on the earlier of (i) the date he renounces citizenship before a diplomatic or consular officer, (ii) the date he provides to the State Department a signed statement of voluntary relinquishment of citizenship confirming an act of expatriation under the Immigration and Nationality Act, (iii) the date that the U.S. Department of State issues a certificate of loss of nationality, or (iv) the date a court cancels a naturalized citizen's certificate of naturalization. The tax would be due on the 90th day after the expatriation date and no tax would be due before 90 days after enactment. The I.R.S. would be authorized to allow a taxpayer to defer payment of the tax for up to 10 years under Section 6161 as though the

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1995).

[20] The exception would apply to all U.S. real property interests, as defined in section 897(c)(1), except stock of a U.S. real property holding corporation that does not satisfy the requirements of Section 897(c)(2) on the date of the deemed sale.

tax were an estate tax imposed by chapter 11. If a taxpayer were determined to hold an interest in a trust for purposes of Section 877A, the trust would be treated as though it sold the taxpayer's share of assets of the trust and the proceeds were distributed to the taxpayer and recontributed to the trust.

Analysis of Proposed Section 877A Under the Administration Proposal and as Modified in the Senate Finance Bill

The Administration Proposal meets the objections to current law Section 877 and Section 7701(b)(10) described above. It deletes the tax avoidance purpose test of Section 877 and does not implicate treaties. Most importantly, it imposes tax on gain determined as of the date a taxpayer ceases to be subject to full U.S. personal taxation jurisdiction and thereby properly measures the gain subject to U.S. personal taxing jurisdiction. As a consequence of these changes, it will be more administrable and not subject to easy avoidance and abuse.

The Senate Finance Bill makes several significant improvements over the text released in the original version of H.R. 981. The definition of when a taxpayer relinquishes citizenship has been modified to relate to the earliest of several substantive acts that manifest an intent to voluntarily relinquish citizenship. This should adequately protect taxpayers who have relied on current law. The I.R.S. authority to extend the time to make payment of the tax is expanded to permit deferral of up to 10 years under rules that are commonly used in the estate tax context. These changes are welcome.

The Administration's Proposal to apply Section 877A to expatriating long-term residents, in addition to U.S. citizens, is reasonable since such individuals are subject to full U.S. personal taxing jurisdiction like citizens. Gains that accrued to their property during residency should not escape U.S. taxation upon their departure.

The Administration Proposal would allow a long-term resident who is not a citizen to take a "fresh start" fair market value basis in his or her assets for purposes of Section 877A as of the date the individual became a resident. I recommend that this provision be broadened and modified. First, it also should apply to an alien who becomes a naturalized citizen. For such aliens, the measuring date should be the earliest of (i) the date the alien becomes a resident alien, (ii) the date the alien becomes a naturalized citizen, and (iii) the date the asset first becomes "effectively connected" with a U.S. trade or business of the alien. Second, the "fresh start" fair market value basis should be for all purposes, not solely for purposes of Section 877A.[21] By limiting the "fresh start" basis to determining gains for purposes of Section 877A, property that is sold while the person is a U.S. resident will be subject to tax on gains that accrued prior to the person becoming a U.S. resident. Such gains arguably should not be caught within the U.S. taxing net. In addition, by subjecting such gains to U.S. taxation if the property is sold while the owner is a U.S. resident, but not if the owner expatriates when he still owns the property, the proposal will have a "lock-in" effect similar to that of the Section 1014 step-up in basis at death. There could be a strong incentive not to sell an asset until after ceasing to be a U.S. citizen or resident. Finally, the fair market basis provision should not be an election; it should be applied across-the-board so that taxation under Section 877A does what it intends to do: accurately measure and tax those gains that accrue while the taxpayer is subject to U.S. personal taxing jurisdiction.

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[21] According to the Joint Committee on Taxation, both Canada and Australia, which both impose a departure tax on residents, treating them as having sold their assets at the time of departure, allow individuals who become residents to take a basis in their foreign assets equal to the assets' fair market value at that time for all purposes. Staff of the Joint Committee on Taxation, *"Background and Issues Relating to Taxation of U.S. Citizens Who Relinquish Citizenship,"* (JCX-14-95, March 20, 1995).

I recommend adding an exception from Section 877A for property that is effectively connected with a U.S. trade or business of the taxpayer. As a corollary to this recommendation, Section 864(c)(7) should be amended to tax a nonresident alien individual subject to Section 877A on gain at the time such an asset ceases to be held for use in the U.S. trade or business.[22]

It should be possible to mitigate double taxation that could occur under the Administration's Proposal by negotiating with treaty partners to increase a taxpayer's basis in property taxed by the United States on expatriation for purposes of taxation by the treaty partner. If taxation at the time of expatriation is adopted, I would urge the Treasury to take such a position in treaty negotiations and, if requested by a taxpayer, under a mutual agreement article's competent authority procedure. To the extent that such a basis step-up would not be allowed under the domestic law of the expatriate's new country of residence (assuming that it imposed an income tax), a well-advised taxpayer could take self-help measures to avoid the second tax.

I reserve comment on other technical aspects of the proposal. In particular, I do not comment, without further study, on the approach taken by the Senate Finance Bill to interests in trusts or to the interaction of Section 877A with estate and gift tax rules. I would be pleased to work with the Committee staff on the details of final legislation.

I respectfully disagree with an asserted "constitutional" objection to this proposal that rests on dictum in the 1920 Supreme Court decision in *Eisner v. Macomber*.[23] In *Eisner*, the Supreme Court defined income not as a gain "accruing to capital", but as something "severed from" capital. It has been suggested that *Eisner v. Macomber* accords constitutional significance to the "realization" principle. However, since 1920, *Eisner v. Macomber* has been distinguished and limited,[24] and, according to at least one court, "insofar as it [*Eisner v. Macomber*] purported to offer a definition of the term income, as used in the Sixteenth Amendment, it has been discarded."[25] Similarly, the weight of scholarship rejects the view that realization is or should be constitutionally required to tax gains.[26] Proposed Section 877A would not be the first provision to tax gains prior to realization. Congress has approved, repeatedly, income tax measures that apply to income that has not been realized by the taxpayer.[27] Section 1256, which was added to

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[22] Consistent with this recommendation and the recommendations in the preceding paragraph, a long-term resident alien's basis in property contributed to his U.S. trade or business should take a fair market value basis as of the date of contribution.

[23] 252 U.S. 189 (1920) (holding that a stock dividend should not be included in taxable income).

[24] *See e.g., Helvering v. Bruun*, 309 U.S. 461 (1940); *Helvering v. Horst*, 311 U.S. 112 (1940).

[25] *United States v. James*, 333 F.2d 748, 752 (9th Cir. 1964).

[26] *See e.g.*, Surrey and Warren, *"The Income Tax Project of the American Law Institute: Gross Income, Deductions, Accounting, Gains and Losses, Cancellation of Indebtedness,"* 66 Harv. L. Rev. 761, 770-71 (1953) ("Essentially the concept of income is a flexible one, with the result in a particular case being determined by the interplay of common usage, accounting concepts, administrative goals, and finally judicial reaction to these forces.").

[27] In 1937, with the foreign personal holding company rules, in 1962 with the controlled foreign corporation rules, and in 1986 with the passive foreign investment company rules, Congress enacted provisions that taxed certain domestic shareholders on undistributed earnings of certain foreign corporations. The constitutionality of the foreign personal holding company rules and the controlled foreign corporation rules have been upheld. *See Eder v. Commissioner*, 138 F.2d 27 (2d Cir. 1943) (upholding U.S. tax on taxpayers owning stock in Columbian company under foreign personal holding company rules, even though distribution of pesos

the Code in 1981, provides that certain regulated futures and foreign currency contracts are marked-to-market on the last day of a taxpayer's taxable year and gain or loss is recognized.[28] Section 475, enacted in 1993, requires securities dealers to mark-to-market securities held in inventory on the last day of the taxable year and recognize gain or loss. Moreover, fairness to taxpayers as well as the Government's revenue interests may require that such mark-to-market treatment be expanded to a broader range of circumstances. It would be extremely unwise for this Committee to adopt the holding of *Eisner v. Macomber* in a way that could be viewed as imposing a constitutionally-based realization requirement.

Conclusion

Proposed Section 877A would constitute an improvement over current law and, modified as suggested above, deserves the strong support of your Committee.

Madame Chairman, this concludes my remarks. I would be pleased to answer any questions that the Subcommittee may have.

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blocked pursuant to Columbian law); *Garlock v. Commissioner*, 489 F.2d 197 (2d Cir. 1973) (upholding constitutionality of requiring shareholders in controlled foreign corporation to include in gross income their pro rata share in the controlled foreign corporation even if there had been no distribution to the shareholders. The court, in fact, stated that the argument that the controlled foreign corporation rules are unconstitutional "borders on the frivolous . . . .").

[28] The Ninth Circuit has passed favorably on the constitutionality of Section 1256, but did not address the realization issue directly. *Murphy v. United States*, 992 F. 2d 929 (9th Cir. 1993).

Chairman JOHNSON. Thank you, Mr. Shay.
Mr. Stephan.

STATEMENT OF PAUL B. STEPHAN III, PROFESSOR, UNIVERSITY OF VIRGINIA SCHOOL OF LAW, CHARLOTTESVILLE, VIRGINIA

Mr. STEPHAN. I have prepared my remarks for the record and I will submit them as they stand. I want very briefly to make a couple of key points with regard to the international law issues that may be raised by this legislation.

I would like to emphasize two distinctions, one of which I think is significant, the other which might seem like hair splitting. I think it is very significant to distinguish emigration from expatriation. Emigration might include expatriation, but it doesn't have to. Expatriation means the renunciation of one's citizenship.

If one focuses on the human rights conflicts of the sixties, seventies and eighties, I think it is absolutely clear that we were concerned with emigration and that questions of renunciation of one's citizenship were tertiary at best.

There has been some discussion of the Jackson-Vanik amendment. One of the witnesses in his prepared testimony suggested that my recollection of those events might be faulty because I was only entering law school. I am always happy to have my youth used against me, but I would point out that 1974 was the year that I left the Central Intelligence Agency to start law school, that my responsibilities at the CIA included political analysis with respect to the Soviet Union and particularly with respect to human rights and immigration issues. That was essentially my account.

So I do feel I know something about the events that inspired the Jackson-Vanik legislation, and I am fairly firm in my recollection that one of the articulated concerns of Congress at the time was that the Soviet Union arbitrarily insisted that those who wished to emigrate also expatriate, were not given a choice as to expatriation. The concern that they also were charged for the expatriation was part of that, but it was clear Congress understood at the time that emigration was distinct from expatriation.

Now, this is not, I think, an immaterial technical lawyer's point. Emigration means your physical security. Expatriation means an ongoing bond with a country which only can be enforced if you come once again within their territory. I don't mean to suggest that expatriation is insignificant. It is not. We have had cases where people have expatriated themselves from the Soviet Union, come back as tourists because they expatriated themselves in the context of World War II. The Soviet Union did not recognize their expatriation and proceeded to prosecute them for what were alleged to be war crimes. I think that was improper.

But that is not at all what this legislation here involves. This is an expatriation-triggered tax. It has nothing to do with emigration in the sense of changing one's residence. If it were otherwise, I would have deep concerns about it.

As a tax on expatriation, this gets into another distinction that may seem more like hair splitting, the distinction between international law and consistent U.S. policy. As a lawyer, I look at international law as an obligation that is enforceable by at least

some means, if even only by the consensus of the international community. I look at instruments, I look at customary international law.

I do not find in any of the instruments that deal expressly with the right to travel, the right to leave one's country, an obligation having to do with expatriation. Neither in customary international law do I find a clearly established right. Indeed we see many constraints on this.

On the other hand, it has been consistent U.S. policy that the right to expatriate exists. Whether or not it is recognized by other nations, it has been our policy, and I think it ought to be respected, I think the United States should not do things that are inconsistent with that policy. But I do not think it is inconsistent with that policy to impose reasonable restrictions that are not discriminatory.

Now, this of course depends on how you characterize this tax, and here I would affiliate myself with Mr. Shay's remarks. If in the abstract, you say, well, the only people who pay taxes on realized gains are people who are changing their citizenship, that is discrimination. But I can flip that and say that the only people who are U.S. citizens who accumulate unappreciated wealth who do not have to face either an income tax or an estate tax, one or the other, not necessarily both, are those people who change their citizenship. In that sense, I think this law, with its imperfections, which I would like to touch on, does simply prevent the expatriating from being treated more favorably than people who remain behind.

Indeed, it is still reasonably favorable, compared to the estate tax, because 39.6 percent on the net is a lot better than 55 percent on the gross under the estate tax. There are, I think, some technical problems here. I touch upon what effective date to use in my remarks. I would be happy to answer questions about those.

Thank you.

[The prepared statement follows:]

Prepared Statement of Professor Paul B. Stephan III on Section 5 of H.R. 831

Madam Chairwoman and members of the Committee, it is an honor to appear before you to discuss the merits of the Administration's proposal to collect an income tax on certain unrealized gains upon the relinquishment of U.S. citizenship. I appear before you in my capacity as an academic specialist on matters of international law, U.S. tax law, and Soviet-American relations. I am sure you are more interested in the strength of my arguments than in my credentials, but for the record I hold the Percy Brown, Jr. Chair and the Hunton & Williams Chair at the University of Virginia School of Law. At Virginia I have taught tax law for sixteen years, as well as a range of international courses. On occasion I have advised various U.S. government agencies on matters of international law, in both Republican and Democratic Administrations. One of the books I have edited, a text on public international law, is used as a course book in both Russia and the United States; my former student Bob Turner, who appears here with me, co-authored one of the chapters. Not that political affiliation matters on questions of this nature, but in 1992 I served as national vice-chair of Law Professors for Bush-Quayle and today am a paid-up member of the Virginia Republican Party.

I understand that you are primarily interested in the question of whether the Administration's proposal would conflict with any obligation under international law to which the United States is subject. In particular, you want to know whether treating renunciation of citizenship as a realization event raises even a suspicion of conflict with the international law of human rights. In addition, there are issues as to the constitutionality of the proposal and its merits as a matter of tax policy. I will dwell principally on the first issue but will touch on the latter two.

In terms of positive international law, there are two multilateral instruments to which the United States is a party that deal specifically with freedom to leave one's country. The first is the International Covenant on Civil and Political Rights, to which the Senate extended its consent to ratification in 1992. The other is the Final Act of the Conference on Security and Cooperation in Europe (Helsinki Accords), signed by the Ford Administration in 1975 but not regarded as a treaty and therefore never submitted to Congress for consent to ratification. Both of these protect freedom of movement. Article 12(2) of the Covenant states that "Everyone shall be free to leave any country, including his own." This language tracks closely that of Article 13(2) of the Universal Declaration of Human Rights, a UN General Assembly Resolution. The Helsinki Accord on Cooperation in Humanitarian and Other Fields, I(d), provides:

> The participating States intend to facilitate wider travel by their citizens for personal or professional reasons and to this end they intend in particular:
>
> —gradually to simplify and to administer flexibly the procedures for exit and entry;
>
> —to ease regulations concerning movement of citizens from the other participating States in their territory, with due regard to security requirements.
>
> They will endeavour gradually to lower, where necessary, the fees for visas and official travel documents.

As a technical matter, the Covenant constitutes an explicit obligation of the United States under international law, although subject to certain reservations expressed by the Senate; the Accords are considered political rather than a legal, although they provide a gloss on the meaning of more general treaties such as the Charter of the United Nations.

These are weighty commitments, and the United States should not violate them. But it is critical to recognize the distinction between the right to travel, on the one hand, and the right to change one's citizenship status, on the other. What becomes immediately clear upon reviewing these instruments is that they deal with the freedom of individuals to cross borders. They are concerned with travel and residence, with physical movement. Citizenship is different: It is an abstract legal relationship that exists regardless of the physical location of the citizen. States should not hold their citizens captive; people should be free to cross borders subject only to reasonable restrictions of a general and nondiscriminatory nature. This important principle has nothing to do with citizenship, but rather with physical presence.

The reason why international human rights law focuses on travel and not citizenship is fairly simple. As long as people are held within a country, they are subject to the full weight of sovereign state power. Once they leave a country's territory, they are freed of an immediate threat of physical coercion and incarceration. Whether persons outside a country's boundaries retain the formal status of citizen or not is an entirely different matter. Citizenship is not meaningless, but a state cannot throw you in jail or torture you simply because it still claims you as a citizen. And it is exactly abuses of state power over people that prompted these human rights instruments.

When one turns to customary international law, one finds the same distinction between freedom to travel and the power to change one's citizenship. Perhaps the clearest statement of the U.S. position on the obligation to permit freedom to travel can be found in the Jackson-Vanik Amendment to the Trade Act of 1974. The Amendment, in part, condemns any state that imposes more than "a nominal tax" on emigration, 19 U.S.C. § 2432(a)(2), and goes on to specify that other duties and charges levied on persons seeking to exercise their right to emigrate similarly are abhorrent. But by emigration, the drafters of this legislation meant leaving the country, not renunciation of citizenship. Indeed, one of the abuses cited at the time was the Soviet practice of requiring emigrants to surrender their Soviet citizenship as a condition of departure. Congress believed that emigration did not involve a change of citizenship, and denounced countries such as the Soviet Union that sought to link the two.

More generally, the human rights concerns that dominated our encounters with the Soviet Union and other totalitarian regimes during the 1970s and 1980s were based on unambiguous violations of the right to travel. Those governments treated their borders as the perimeter of a prison, and their citizens as prisoners. The so-called education tax that the Soviet Union threatened to impose on emigrants, which inspired the above cited language in the Jackson-Vanik Amendment, was triggered by a request to travel abroad, not by an attempt to renounce Soviet citizenship.

I do not mean to suggest that the refusal of a state to permit a nonresident person to renounce his citizenship is never a matter of concern under the international law of human rights. Early in our nation's history, we protested vigorously, even to the point of war, when nations such as England would claim as their own citizens and seize American sailors found on the high seas. But this problem is different in kind from that presented by the freedom to travel. And today the conduct that triggered the American protests—arbitrary seizure of persons on the high seas—would likely be seen as a human rights violation regardless of any claims of citizenship.

The Administration's proposal, as I understand it, has absolutely no effect on the right of a citizen to travel abroad. It is triggered only by a change of citizenship status, not by the crossing of our country's borders. The reason for this distinction is clear when one considers how U.S. tax rules operate. Whether a citizen resides within or without the United States, the obligation to pay tax on appreciation of assets remains the same. Any gain realized and recognized during life will result in an income tax. Any unrecognized appreciation that remains at death will not be subject to an income tax, but instead will subject the decedent to the estate tax. To be sure, the federal estate tax is not an exact substitute for an income tax at death on unrealized appreciation, both because only wealthy persons (those with assets in excess of $ 600,000, assuming no taxable gifts during life) are subject to the estate tax, and because the taxable estate includes both realized and unrealized appreciation. But I am not alone in having pointed out that the estate and gift tax, in practice, serve as a reasonable approximation for the income tax that could be levied on unrealized appreciation at death.

All of the above turns on citizenship, not on residence. A U.S. citizen who resides abroad will have to include in his tax base any gain realized from the disposition of an asset, *see Cook v. Tait*, 265 U.S. 47 (1924), will pay a federal gift tax on any taxable gift during his life, no matter where the asset is located, and will include all of his worldwide assets in his taxable estate at death. By contrast, a person who severs the bond of U.S. citizenship and does not continue to reside in the United States will pay neither income, gift, nor estate tax (except as to U.S.-sourced income and, for the estate and gift tax, transfers of certain property sourced to the United States). The change of citizenship status, not of residence, is what matters for U.S. tax law. Current law recognizes the significance of changes in citizenship by subjecting nonresident aliens who lose U.S. citizenship for tax avoidance reasons to a special alternative income tax, *see* Internal Revenue Code Section 877. Section 2107 imposes a similar result with respect to the estate tax, and 2501(a)(3) with respect to the gift tax. What the Administration proposal would do, as I understand it, is replace the unworkable tax avoidance standard of Sections 877, 2107 and 2501(a)(3) with a *per se* rule that applies to any person with sufficient assets to make future estate taxation a probability. An analogous provision is Section 367 of the Code, which denies nonrecognition treatment in certain corporate reorganizations if the recipient of appreciated property is a foreign corporation. I never have heard the argument that the latter provision imposes an impermissible burden on the right of a domestic corporation to export its capital.

In summary, the international law of human rights is concerned almost entirely with restrictions on the right to leave one's country, not those on the right to renounce one's citizenship. To the extent human rights law deals with citizenship status, it addresses involuntary denials of citizenship, not burdens triggered by the renunciation of citizenship. Furthermore, the proposed measure is not a tax on the export of capital as such, but rather a logical part of a comprehensive scheme to ensure that all appreciation of capital owned by a U.S. citizen eventually will be subject to a U.S. tax, whether income, gift, or estate. For these reasons, it is inconceivable to me that the Administration's proposal could be seen as violating international human rights law.

Next, is the Administration's proposal unconstitutional? Here the issue is the enduring validity of *Eisner v. Macomber*, 252 U.S. 189 (1920). You will find in the analysis of the Joint Committee all of the relevant precedent, and its judgment that the realization requirement no longer

has a constitutional basis is one that I have expressed in print on several occasions. To appreciate why this conclusion is persuasive, if not ineluctable, one should recall that *Eisner* itself rested on *Pollock v. Farmers' Loan & Trust Co.*, 158 U.S. 601 (1895). That notorious case struck down the 1894 federal income tax on two grounds: a tax on income functioned as a direct tax in violation of Article I, Section 9, Clause 4, and a tax on interest paid by States on their debts amounted to a violation of intergovernmental immunity. The second prong of *Pollock*, namely its holding on State immunity from federal taxation, was explicitly overruled by the Supreme Court in *South Carolina v. Baker*, 485 U.S. 505 (1988). The first prong was a wholly illegitimate exercise of judicial lawmaking, contrary to the intent of the framers and the Court's own precedent. The direct taxes prohibition of Article I was motivated by a concern that the federal government, dominated by a coalition of poorer States, would impose a real estate property tax that would disproportionately burden the rich landowners of New York, Virginia, and a few other prosperous States. Income taxation as such did not exist then, and the framers did not have it in mind when they crafted the language of Article I. The *Pollock* Court was not at all interested in wealth redistribution among the States, clearly the framers' only concern, but rather with the social and economic implications of progressive taxation, a problem addressed, if at all, only in the Takings Clause of the Fifth Amendment. It is not surprising, therefore, that the first prong of *Pollock*, on which *Eisner* rests, has become so irrelevant that the modern Court has never felt the need explicitly to overrule it.

Finally, I would like to touch on the wisdom of this measure as a matter of tax policy. Whether you should like this proposal or not, I believe, turns on what you think of the federal estate tax. If you think the estate tax is an appropriate mechanism for addressing a significant deficiency in a realization-based income tax that steps up basis at death, then you should support the proposal. It deals only with holdings that are outside the estate tax's zero bracket, it excludes property that will be subject to the estate tax regardless of the decedent's citizenship and residence, and it provides a much cleaner and easier-to-administer rule than current law's tax avoidance standard. If, on the other hand, you want to abolish the estate tax, then you also should reject the proposal.

I can appreciate the merits of a system that only taxes consumption and leaves returns to capital out of the base. For now, however, that is not our system. What I cannot understand is a system that generally levies a tax on capital appreciation, but excludes appreciation belonging to persons willing to renounce their ties to the United States. That simply makes no sense to me.

There is one technical point, however, on which the bill should be improved. Proposed Section 877A(e)(2) would fix the time of the tax as of date an individual notifies the Department of State of the performance of an act of expatriation as specified by paragraphs (1) through (4) of Section 349(a) of the Immigration and Nationality Act (if this is earlier than any of the other expatriating events specified in Section 877A(e)). But as I understand the Immigration and Nationality Act, a person loses his citizenship when he performs the specified act, not later if and when he notifies the Secretary of State. *Cf. Vance v. Terrazas*, 444 U.S. 252 (1980). There is no reason why the tax rule should be any different from the citizenship rule. The timing of the tax should not turn on the formality of notice, which an individual might manipulate to reduce his burden. Indeed, I could imagine a case where a person loses his citizenship through an act of expatriation but never notifies the Department of State that he has done this. At death such a person could claim immunity from the estate tax because of his status as a nonresident alien, but because of the lack of notice to the State Department would not have been subject to tax under proposed Section 877A. I therefore recommend that the language of Section 877A(e)(2) be amended to make clear that the date of the tax should be when the specified act of expatriation occurs, not when notice is given. This would also affect when the enacted tax would first take effect, because persons who have performed acts of expatriation without a tax avoidance purpose before February 6, 1995, would not be covered by Section 877A. Since there is no good reason to make this tax retroactive, I would assume this change would be uncontroversial.

Chairman JOHNSON. Thank you, Mr. Stephan.
Rabbi Moline.

STATEMENT OF RABBI JACK MOLINE, VICE PRESIDENT, WASHINGTON BOARD OF RABBIS, WASHINGTON, DC

Rabbi MOLINE. Madam Chairperson and Members of the Subcommittee, thank you for inviting me to testify today regarding the proposed expatriation tax. I serve as the rabbi of Agudas Achim Congregation in Alexandria, Virginia. I have held leadership positions in the Washington Board of Rabbis and the Rabbinical Assembly of Conservative Judaism. I mention those credentials not because I represent those organizations in my testimony, I do not. It is simply to indicate that my perspective and concerns are not unusual among the leadership of Jewish community in the United States and abroad and I respectfully ask you to reject this tax.

I have spent many years struggling with foreign governments on behalf of Jews wishing to leave oppressive societies for the freedom afforded by our country and others. I traveled to the Soviet Union in 1978 for the purpose of meeting Jews who wanted to emigrate but were denied that opportunity on the basis of legal technicalities and most onerously, excessive taxes placed on their request to emigrate. They were described beautifully by Professor Turner.

Their stories were heartbreaking and indeed many Members of Congress remember well their own advocacy on behalf of these refuseniks.

I also had the privilege of serving a congregation whose membership includes Jews from many countries. Among the families is a large extended family from Iran. The restrictions placed on their emigration were so severe that young and old alike, they had to endure torturous overland trips and be smuggled out of Iran leaving behind all their possessions.

I might add that this family was well-to-do in Iran, but they were unable to afford the taxes that were placed upon emigrants. In order to reach freedom, they had to abandon all their property. The few members of their family remaining in Iran live in fear of the seizure of their property and possessions as payment for the emigration of others.

Our government responded to such tactics by taking the moral high ground. The Jackson-Vanik amendment successfully enacted 20 years ago used the human rights issue as the wedge to the most accessible crack in Soviet culture. By making clear our willingness to sacrifice gains in trade and influence for the cause of human rights, the United States established itself as a champion of its own principles: Life, liberty, and the pursuit of happiness, and now that moral high ground is threatened.

A small group of wealthy Americans, seeking to avoid the responsibilities of citizenship, seems to be a lucrative and popular target for much needed revenue in a time of fiscal crisis. And nobody, including me, has much sympathy for the greed which motivates their actions. But the abuse of our freedom by a few does not call for legal remedies which lay the groundwork for threatening the freedom of the many. For while we Americans may understand the fine lines we draw regarding income, assets, capital gains and tax

liabilities, foreign dictators will find them irrelevant. The arguments are the same. We simply draw the line in a different place.

Any number of times I have sat face to face with representatives of the Soviet Government and heard them defend exit taxes on the basis of repaying a debt to society. The claim was that there had been an investment in the Jews who wished to emigrate. They were educated in the USSR, that they had enjoyed health care, guaranteed employment, housing and security, that they had served in the military and they knew secrets. If they wished to take the fruits of their life away from the tree which bore them, then it was reasonable to reimburse the workers who must remain behind to pick up the slack. Such ingrates were to be punished for rejecting the blessings of Soviet society. They would repay their benefactors for the decision not to endorse the particular social contract and political agenda of that country.

I heard the same arguments articulated by a staff member of a congressional Committee just last week and I was horrified. This tactic has been used not only by the Soviets and the Iranians but by the Iraqis, the previous government of South Africa, pre-Zimbabwe, Rhodesia, and, to add to this rogues' gallery, Adolf Hitler's Germany.

The victims have been the disenfranchised of every ilk, not just Jews, but Bahais and Christians and Muslims, black majorities and white minorities. This provision would begin the construction of a wall around this country. The wall would not defend us against hostile invaders but imprison those who wish to leave. Mr. Guttentag himself offered that opinion in his testimony.

The limited application and target population of this provision may look safe in the short term, but the precedent it sets is frightening in its potential to undermine our basic commitment to human rights and it eviscerates Jackson-Vanik.

I make no representation as to whether this provision passes muster under the Constitution or international law. I also make no representation about whether this is good tax policy. Discussions on those matters will focus on technicalities and twists of language, on graphs and on growth theories.

I raise only the overarching moral questions, do we wish to trade a short-term economic gain for the standing we have as the exemplars of human rights, even for those who exercise them in unpopular ways? I assure you, I wish no peace to those who abandon this great country for material gain, but I can live with my resentment of the success of their greed and manipulation. I would be humiliated, however, if I spoke up on behalf of an oppressed minority anywhere, and I will, and had to respond to some smug tyrant who waved a copy of this provision in my face.

I appreciate your willingness to hear my testimony. These conclude my remarks and I am available for any questions.

Chairman JOHNSON. Thank you. Thank you very much, Rabbi Moline.

Ms. McCaffrey.

STATEMENT OF CARLYN S. McCAFFREY, ESQ., PARTNER, WEIL, GOTSHAL & MANGES, NEW YORK, NEW YORK

Ms. MCCAFFREY. Madam Chair, Members of the Subcommittee, I welcome the opportunity to share with you the concerns I have with Treasury's proposal to impose a tax on citizens who give up their citizenship.

I am a tax partner at the law firm of Weil, Gotshal & Manges, a member of the adjunct faculty of law at the New York University School of Law and have practiced and taught tax and trusts and estates law for more than 25 years. I appear today in my individual capacity and I am going to talk about tax and trust law.

The proposed legislation would replace the provisions of current law that subject former citizens to tax on U.S. source income for 10 years if a principal purpose of expatriation was to avoid U.S. tax. The problems with the current expatriation rules are well known. The requirement of a tax avoidance motive provides a reason for not reporting and creates an obstacle to enforcement. The 10 years may be insufficient to capture all gain that should be caught, and as Mr. Shay told us earlier this afternoon, tax practitioners have created various techniques over the years that make it quite easy to avoid its reach.

These factors have all combined to enable individuals to avoid tax on income and unrealized gain that accrue during periods of U.S. citizenship.

I agree that the Code should be strengthened to ensure that income and gain that accrued while an individual was enjoying the advantages of U.S. citizenship do not escape U.S. taxation. Treasury's proposal, however, extends far beyond that legitimate objective. My concerns with the bill relate both to its substance and to a number of technical flaws.

As to substance, I am concerned that expatriation is not an appropriate tax event and with the proposed scope of the tax as well. The bill treats relinquishment of U.S. citizenship as a tax recognition event. The event of expatriation, it seems to me, is not an appropriate recognition event since it produces neither the cash to pay the tax, nor a way of accurately measuring an individual's gain or loss and their assets.

As Mr. Guttentag testified, the bill attempts to deal with the liquidity problem by extending the estate tax deferral provisions to the expatriation tax. These provisions permit the Internal Revenue Service, for reasonable cause, to extend the time for the payment of the estate tax for 10 years. At current rates, deferral requires the payment of interest at 9 percent compounded daily. A taxpayer who defers using this provision will risk incurring an interest obligation to the United States that ultimately exceeds her profits from her retained assets. In most cases, this will not be a viable or a sensible option.

Although expatriation should not be a recognition event, this doesn't mean that an expatriate should escape U.S. income tax. There are reasonable alternatives that should be explored that are consistent with our general policy of deferring tax on income until collection and on gains until recognition.

One alternative is to require an expatriate to identify the assets she holds at the time of expatriation and to require her to pay U.S.

income tax on those assets when they are actually sold or transferred by gift for a debt to the extent that they are not subject to the U.S. gift or estate tax.

In terms of timing and measurement, the expatriate would then remain in the same position as a U.S. citizen. I think this should be the objective. Collection of the tax could be assured by requiring a bond or a deposit of assets in the U.S. trust. A similar technique is now required by the U.S. estate tax law in connection with the allowance of a marital deduction for bequests to noncitizen spouses.

An easier and perhaps better alternative, as several witnesses have suggested earlier this afternoon, is simply to strengthen the provisions in existing law that impose an income tax on an expatriate's U.S. source income for 10 years. The exception for non-tax-motivated expatriations could be eliminated, and most importantly, the sections that impose a tax on the transfer of appreciated property to foreign corporations, partnerships and trusts could be amended to apply to transfers by expatriates during the 10-year period.

In fact, most of the abuse that centers around section 877 probably stems from an inadvertent change to section 367 as part of the 1976 reform act. Before that date, section 367 would have caught any expatriate who transferred assets to a foreign corporation, but that was changed and since then it has been fairly simple to avoid 877 by making transfers of that sort.

If these steps were taken, it is likely that the United States would tax most of the income and gain that should be taxed and would do so without creating a new layer of complex Code provisions that would require a long process of technical corrections and regulations to be workable.

As to the scope of the tax, the bill treats the expatriating citizen as owning those assets that would have been included in her gross estate if she had died on the date of expatriation, certain interests and trusts, including discretionary trusts, and any other interest in property specified by the secretary.

These categories are too broad because they reach assets which the individual doesn't own and to which he has no access. Additionally, it reaches property that probably would never have been subject to any U.S. tax at all if the individual had retained her citizenship.

The bill's application of the tax to a beneficiary's interest in a discretionary trust created by another reflects a disregard for the reality of those rules of trust law that stand between a beneficiary and the assets of a trust. When a beneficiary is subject to tax on account of her interests in a trust, she won't be able to compel the trustee to distribute assets, nor will she be able to sell her interest in the trust. Unless she has sufficient other assets to pay the tax, this new expatriation tax will make it economically impossible for her to relinquish her citizenship.

In addition to my concerns with the substance of the bill, I have a number of technical concerns that are explained in my written statement. But I would like to summarize just a few of them now.

The first four problems that are described can combine to result in a U.S. income tax, a foreign income tax and a U.S. estate or gift

tax on the same amount of gain all without any adjustment to avoid what could amount to a tax in excess of 100 percent.

As described in my written statement, the bill appears to reach all rights to receive future income, including the alimony rights an expatriating husband or wife takes when he or she returns to his or her native land and expatriates after a divorce.

The consequence of this provision is not only to tax the expatriate on the present value of rights to future alimony, but also to deny an alimony deduction to the paying spouse who remains behind.

Finally, no attempt has been made in the bill to deal with the very difficult problem of creating a rational system for the future taxation of a trust and its beneficiaries after one of its beneficiaries has expatriated, causing a portion of the trust assets to be subject to tax.

Last week, Mr. Samuels concluded his testimony on this bill before the Senate Finance Committee by stating that, Americans who avoid their tax responsibilities by expatriating should not be rewarded. Instead, they should be asked to pay tax that U.S. citizens will pay sooner or later.

I agree. They should be asked to pay, but a tax paid sooner is obviously more burdensome than one paid later, and a tax paid on assets that may never be received creates what appears to be an unconscionable burden. To ask an expatriate to assume a greater burden than a similarly situated citizen creates an unseemly exit tax. It punishes a politically unpopular group of U.S. citizens for choosing to exercise their right to give up their citizenship.

This concludes my prepared remarks, and I would be happy to answer any questions.

[The prepared statement follows:]

HEARINGS ON H.R. 831 BEFORE THE SUBCOMMITTEE ON OVERSIGHT OF THE COMMITTEE ON WAYS AND MEANS UNITED STATES HOUSE OF REPRESENTATIVES

MARCH 27, 1995

STATEMENT BY CARLYN S. McCAFFREY

Madame Chair and members of the Subcommittee, my name is Carlyn McCaffrey. I welcome the opportunity to share with you the serious concerns I have with Treasury's proposal to impose a tax on U.S. citizens who renounce their citizenship.

I am a tax partner at the law firm of Weil, Gotshal & Manges, a member of the adjunct faculty at the New York University School of Law and have practiced and taught tax and trusts and estates law for more than twenty-five years.

The proposed legislation would replace provisions under current law that now subject expatriating citizens to U.S. tax on U.S. source income for 10 years after expatriation if a principal purpose of the expatriation was to avoid U.S. tax. It is part of a larger legislative proposal to expand the exposure of foreign trusts and their U.S. beneficiaries to U.S. reporting requirements and tax.

The problems with the current expatriation rules, set forth in Code Sections 877, 2107, and 2501(a)(3), are well known. The requirement of a tax avoidance motive provides taxpayers a basis for not reporting taxable events, and presents an obstacle to enforcement. The 10 year limitation may be insufficient to capture all gain that should be captured. Over the almost thirty years since these provisions were enacted, tax practitioners have created various techniques that make it easy to avoid its reach. These factors have all combined to enable individuals to avoid tax on income and unrealized gain that accrue during periods of U.S. citizenship.

The Code should be strengthened to ensure that income and gain that accrued while an expatriate was enjoying the advantages of U.S. citizenship do not escape U.S. taxation. Expatriates should be taxed on such gain and income in the manner they would have been taxed if they had not expatriated. Treasury's proposal, however, extends far beyond that legitimate objective. It does so by taxing an event that does not appropriately measure an expatriate's income or gain from any asset and that does not give her the funds to use to pay the tax.

Treasury's expatriation proposal, since its announcement on February 6, 1995, has had two versions, one in section 201 of H.R. 981, which was introduced on February 16, 1995, and one in an amendment to H.R. 831, which was approved by the Senate on March 24, 1995. The principal difference between the two versions is the deletion from the later version of a

similar tax on resident aliens who give up their residency. My comments today relate to the latter version.

My concerns with the Bill relate both to its substance and to its technical structure.

THE SUBSTANCE OF THE PROPOSAL

1. ***The Taxable Event.*** H.R. 831's treatment of the relinquishment of U.S. citizenship as a tax recognition event imposes a cost on expatriation. This cost is not necessary to prevent the avoidance of U.S. tax on income and gain accrued prior to expatriation. As suggested above, the event of expatriation is not an appropriate tax recognition event since it produces neither the cash to pay the tax nor a way of accurately measuring an individual's gain or loss in any particular asset.

The Bill attempts to deal with the liquidity problem by extending the provisions of Code Section 6161 to the expatriation tax. Code Section 6161 permits the Internal Revenue Service, for "reasonable cause" to extend the time for the payment of the estate tax for a period not in excess of 10 years. The examples of "reasonable cause" provided in Treas. Reg. § 20.6161-1 all require a lack of sufficient liquid assets to pay the tax. No option is given to a taxpayer to elect to defer because she wants to retain an asset for investment reasons. Moreover, deferral will require the payment of interest on the deferred tax. A taxpayer who is given the opportunity to defer will risk incurring an interest obligation to the U.S. that ultimately exceeds her profits from her retained assets. In most cases, this will not be a viable or sensible option.

Expatriation should not be a recognition event. But, this does not mean that an expatriate should escape U.S. income tax on income and gains accrued at the time of expatriation. Alternatives that are consistent with our general policy of deferring tax on income until collection and on gains until recognition should be considered.

One alternative is to require an expatriate to identify the assets she holds at the time of expatriation and to require her to pay U.S. income tax on those assets when they are actually sold or transferred by gift or at death, to the extent not subject to the U.S. gift or estate tax. This approach would preclude an expatriate from avoiding U.S. tax on income and gain appropriately taxed in the U.S. by relinquishing citizenship without artificially accelerating the imposition of tax. In terms of the timing and measurement of tax, the expatriate would remain in the same position as U.S. citizens. This should be the objective. Collection of the tax could be assured by requiring a bond or the deposit of the assets in a U.S. trust. A similar technique is required by the U.S. estate tax law in connection with the allowance of the marital deduction for bequests to non-citizen spouses. See Code Section 2056A.

Another alternative is to strengthen the provisions in existing law that impose an income tax on an expatriate's U.S. source income for 10 years after expatriation. The exception for non-tax motivated expatriations could be eliminated and Code Sections 367 and 1491, the

sections that impose a tax on the transfer of appreciated property to foreign corporations, partnerships, and trusts, could be amended to apply to transfers by expatriates during such 10 year period.[1] If this were done, it is likely that the U.S. would tax most of the income and gain that accrued prior to expatriation.

2. ***The Scope of the Tax.*** H.R. 831 treats the expatriating citizen as owning: (1) those assets that would have been included in her gross estate if she had died on the date of expatriation, (2) certain interests in trusts, and (3) "any other interest in property specified by the Secretary as necessary or appropriate to carry out the purposes of this section."

These categories are too broad because they reach assets to which the individual has no access. As a result, she will have no funds to use to pay the tax either at the time of expatriation or, if deferral is permitted, at any later date.

In some cases, the lack of access is attributable to action taken by the expatriate before the announcement of H.R. 831; in others, it is attributable to action taken by a third party over which she has no control. Examples of assets in the first category include certain assets that have been given away irrevocably within three years of expatriation, and interests held in trusts created by the individual with respect to which she has retained a limited right such as the right to receive income or a power to select among alternate beneficiaries. Examples of assets in the second category include an individual's interests in trusts created by others of which she is a discretionary beneficiary.

The Bill's application of the expatriation tax to a beneficiary's interest in a discretionary trust created by another reflects either a disregard for or a disbelief in the reality of those rules of trust law that stand between a discretionary beneficiary and the assets of a trust. When an expatriating beneficiary is subject to tax on account of her interest in a trust, she often will not be able to compel the trustee to distribute trust assets to her nor will she be able to sell her interest in the trust. Unless she has sufficient other assets to pay the tax, the expatriation tax will make it economically impossible for her to relinquish her citizenship.[2]

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1. Curiously, until 1976, Code Section 367 did apply to transfers to foreign corporations by expatriates. The exclusion of expatriates by the amendments made to Code Section 367 by the Tax Reform Act of 1976 (P.L. 94-455, § 1042(a)) was probably inadvertent. Such inadvertent changes are symptomatic of a legislative process that often proceeds too quickly with changes to the Internal Revenue Code. The current complexity of the Internal Revenue Code and the intricate pattern of relationships among its various sections create a high degree of risk that a change to one provision will have an unexpected and undesirable impact on another.

2. The reality of these rules has been made clear in a series of state court decisions that refuse to compel the trustees of discretionary trusts to make distributions to beneficiaries who are welfare recipients. *E.g.*, *Lang v. Commonwealth*, 515 Pa. 428,

(continued...)

The final category raises additional concerns as to the scope of Treasury discretion. To grant Treasury unlimited discretion to characterize any item of property as held by an individual for purposes of the tax creates an unacceptable degree of uncertainty as to the scope of the provision.

The Bill exempts the first $600,000 of gross income attributable to the deemed sale. The use of this figure, which is equivalent to the maximum amount that most U.S. taxpayers may give or bequeath free of U.S. estate or gift tax, suggests a connection between the expatriation tax and the U.S. transfer tax system. It is unclear whether the use of this number is coincidental or if its use signals an eventual attempt to extend the principles of this tax to the transfer tax system.

TECHNICAL CONCERNS

1. ***Foreign Gains Are Subject to U.S. Tax.*** The same logic that justifies subjecting the expatriate to U.S. tax on income and gain that accrued while she enjoyed the benefits of U.S. citizenship or residency compels the conclusion that any income or gain that accrued in any U.S. person's assets before the time she became a resident of the U.S. or prior to her receipt of such assets from a foreign donor or decedent should be protected from the expatriation tax and from all other U.S. income taxes by appropriate basis adjustments.[3] The Bill contains no basis adjustment for either purpose.

2. ***Two U.S. Income Taxes May Be Imposed on the Same Income.*** If an individual is deemed to have sold her assets upon expatriation for an amount equal to fair market value, her basis in such assets should thereafter be adjusted to fair market value. The basis adjustment is significant because the expatriate, for a variety of different reasons, may continue to be subject to U.S. income tax. Instead of providing for such a basis adjustment, the Bill directs Treasury to draft regulations to permit an adjustment. The basis adjustment provisions should be a part of the Bill. The expatriate should not be required to await the issuance of regulations in order to determine her basis in assets which are deemed to have been sold and on which tax has been imposed.

Additional technical problems arise for the expatriate who pays an expatriation tax on an asset that will continue to grow in value and that will be disbursed to her over a period of time. The type of technical problems that will arise can be illustrated by the following example:

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2. (...continued)
528 A.2d 1335 (1987); *First Nat'l Bank of Maryland v. Department of Health & Mental Hygiene*, 284 Md. 720, 399 A.2d 891 (1979); *Portsmouth v. Shackford*, 46 N.H. 423 (1866).

3. The basis adjustment suggested for individuals immigrating to the U.S. is often referred to as "landed basis."

Example 1: Kate is an employee of the X Corporation. Under the terms of her unqualified deferred compensation arrangement with X, she will be entitled to receive annuity payments from X when she retires in 10 years. The annuity payments will be equal to 50% of her highest annual compensation. X transfers her to a foreign country and she expatriates. At the time of her departure from the U.S. and her expatriation, the value of her deferred compensation arrangement is $400,000. When she begins receiving annual payments of $100,000, how will she be taxed? Will the first payments received be excluded from U.S. income tax until she has collected the $400,000 on which she already has paid the income tax? Or, will she be required to allocate the $400,000 over the number of years of expected payments? When will X be able to deduct the $400,000 - on expatriation or on actual payment?

3. ***A Foreign Tax and a U.S. Tax May Be Imposed on the Same Income.*** When the expatriate later sells an asset on which the expatriation tax has been paid, she is likely to be subjected to tax on the same gain by her country of residence. If she had not surrendered her U.S. citizenship before the sale, she would have been protected from double tax by the U.S. foreign tax credit. The imposition of two taxes on an expatriate is a penalty that would not have been imposed on her if she had become a nonresident without surrendering her U.S. citizenship. To avoid the double tax penalty, the U.S. foreign tax credit provisions should be amended to permit a refund of the expatriation tax to the extent of the foreign tax credit that the U.S. would have permitted an expatriate if she had not surrendered her citizenship before the sale.

4. ***A U.S. Income Tax and a U.S. Gift or Estate Tax May Be Imposed on the Same Income.*** If an expatriate is subjected to the expatriation tax on gain accrued in a particular asset and if she later gives that asset away or dies holding it, the gain on which the expatriation tax was paid may be subject to a U.S. gift or estate tax. The combination of the two taxes can exceed 99%. An adjustment should be provided to prevent this result.

5. ***The Exemptions Are Too Narrow.*** The Bill exempts interests in U.S. real estate, interests in qualified pension plans, and interests in foreign pension plans (under regulations prescribed by Treasury up to $500,000). It is understood that U.S. real estate interests are excluded because these will continue to be subject to U.S. income tax under Code Section 897. But U.S. real estate interests are not the only assets that will continue to be subjected to U.S. income tax. A nonresident alien is also taxed on income effectively connected with a trade or business conducted within the United States under Code Section 871(b). Assets used in connection with such a trade or business should similarly be exempted.

6. ***Deduction for Personal Losses May Be Allowed.*** The calculation of the expatriation tax provides that, "notwithstanding any other provision" of the Code, all gains or losses are to be taken into account. A literal application of this provision would permit the expatriate to reduce investment gains by losses on personal assets. Such losses are not ordinarily deductible. It is not clear that this was intended.

7. ***Alimony and Other Rights to Future Income May Be Taxed.*** The Bill does not exempt rights to future payments of income. As a result, it appears to reach rights that it may not be intended to reach. If it is intended to reach these rights, technical changes must be made to other provisions of the Code to preserve the structural balance between income and deductions.

For example, subjecting an expatriating divorced spouse's right to receive future alimony payments seems inappropriate. The right to receive alimony relates not so much to gain that accrued under the protection of the U.S. but to the future support needs of the alimony recipient. But, if the Bill is intended to reach alimony payments, Code Section 215, which allows an alimony deduction only when a payment is actually made and then only if included in the gross income of the receiving spouse under Code Section 71, should be amended to avoid the loss of the deduction to the paying spouse. In addition, Code Section 71(f) should be amended to remove the possibility of the so-called "front-loading" tax if the expatriation of an alimony recipient is treated as an accelerated payment of alimony.

8. ***The Trust Provisions Are Flawed.*** As indicated above, the Bill treats an expatriate as owning certain interests in trusts. The method by which such interests are to be determined is unclear. Moreover, the manner in which the Bill subjects such interests to the expatriation tax is technically flawed and fundamentally inconsistent with existing statutory methods for taxing trusts and their beneficiaries.

a. ***Determining the Beneficiary's Interest.*** A beneficiary's interest in a trust is to be determined based upon "all relevant facts and circumstances" including, not only the terms of the trust instrument, but also a group of factors that, at best, reflect the expatriate's expectations as to her trust interest rather than any definable property interest. These include "any letter of wishes or similar document, historical patterns of trust distributions, and the existence of and functions performed by a trust protector or any similar advisor."

Except where an individual's trust interest can be actuarially valued, as in the case of an interest such as the right to receive trust income for a term, it is impossible to predict how these factors can possibly be utilized to measure an individual's interest in a trust.

An alternate method is provided for those cases where a beneficiary's interest cannot be determined based on facts and circumstances. The alternate method treats the beneficiary or beneficiaries who have the closest degree of kinship to the grantor as holding the trust interests regardless of whether she has any actual access to or expectation of receiving trust distributions. The application of this approach can be illustrated by the following example:

Example 2: Mary established a discretionary trust for her all of her issue 10 years ago. The terms of the trust instrument give complete discretion to a corporate trustee as to the timing and amount of distributions. The trust is to

last until the last to die of Mary's issue living at the time of the trust's creation. At that time, all trust property will be paid to charity. When Mary created the trust, she had three living children and ten living grandchildren. Ten years after the trust's creation, Maureen, one of Mary's daughter's expatriates. Maureen's two sisters are alive at the time of expatriation. There are no letters of wishes and no trust protector or advisor. No distributions have ever been made because the trustee has determined that none of Mary's issue is in need of funds. Maureen has no reason to believe she will ever receive any distributions from the trust. Since it is impossible to determine trust interests on the basis of facts and circumstances, Maureen will be deemed to hold one-third of the trust.

In the case of a grantor trust whose grantor and beneficiary expatriate, the Bill appears to impose the expatriation tax on both of them with respect to the same trust assets. The report entitled "Background and Issues Relating to Taxation of U.S. Citizens Who Relinquish Citizenship" prepared by the Staff of the Joint Committee on Taxation dated March 20, 1995 states that this result is not intended. Language should be added to the Bill to make this clear and to explain how to treat trusts that are only partially grantor trusts.

b. ***Calculating the Tax.*** The expatriate who is deemed to hold an interest in a trust must calculate her expatriation tax allocable to the trust interest in the following manner:

(1) The Bill appears to assume that the expatriate's interest will be quantifiable as a percentage share of the trust as a whole. This share is then to be treated as a separate trust.

(2) The deemed separate trust is then deemed to have sold all of its assets for their fair market value immediately before the beneficiary expatriates and to have distributed all such assets to the expatriate.

(3) The expatriate is then deemed to have recontributed the distributed assets back to the trust.

It is understood that the object is to require the expatriate to include in her gross income any gain deemed to have been recognized on the deemed sale as well as any previously undistributed income allocable to the beneficiary's share. This result, however, interacts uneasily with the various existing methods for taxing trusts and their beneficiaries and creates a number of anomalies and unanswered questions. For example:

(1) Will capital gain realized on the deemed sale of assets be included in distributable net income so that the deemed distribution to the beneficiary will make the beneficiary (rather than the trust) taxable on capital gain? Normally capital gain is not included in distributable net income of a domestic trust.

(2) Will these rules apply if the trust actually sells assets and distributes amounts to the expatriating beneficiary?

(3) After the expatriate is treated as having recontributed the assets to her separate trust, will the trust continue to be treated as a separate trust so that she will receive the benefit of the basis adjustment to the contributed assets if they are distributed to her in the future? If so, how will the trust treat future distributions? In the example set forth above, will future income distributions from the trust to any beneficiary other than Maureen be treated as coming from the two-thirds share of the trust that is not her share? If so, an actual distribution of all trust income to Maureen's sister will give rise to a deduction of only two-thirds of such income. The sister will pay tax on only two-thirds of the income while tax on the remaining income will be imposed on the trust.

(4) How will the deductions of the trust, such as the deductions for expenses and charitable contributions, be allocated and reflected in the expatriate's tax calculation?

(5) For what tax purposes will the expatriate be treated as having received a distribution? If she is a grandchild of the trust's grantor (or otherwise assigned to the grantor's grandchildren's generation), will she be subject to the generation-skipping transfer tax on account of her receipt of a taxable distribution? If so, will the generation-skipping transfer tax be deductible in computing the expatriation tax. Arguably, expatriation should not accelerate the generation-skipping transfer tax. If it does not, the generation-skipping transfer tax should be amended to permit the expatriate to reduce the amount of any future actual taxable distributions by the expatriation tax.

(6) For what tax purposes will the expatriate be treated as having recontributed the assets? Will she be subject to the normal gift and estate tax consequences that flow from contributions to trusts? If she is a child of the trust's grantor (or is otherwise assigned to the grantor's children's generation), will she be treated as the transferor of the trust for generation-skipping transfer tax purposes, thereby avoiding the generation-skipping transfer tax on subsequent distributions to the grantor's grandchildren.

(7) In the case of an expatriate whose trust interest consists of an income interest, should such recontribution be treated as a purchase of an income interest so that she would be able to take an amortization deduction against future income distributions? If so, Code Section 167(e), which generally precludes the amortization of term interests when related persons hold the remainder interests, should be amended.

(8) Will the expatriate's share of the trust be treated as a so-called "grantor trust" as to the recontributed share with the result that all items of income, deduction, and credit allocable to her share will be attributable to her?

(9) In the case of an interest in a charitable remainder trust, how is the distribution to be allocated among the various categories of accumulated income? Will the expatriate receive a charitable deduction for the deemed recontribution of assets back to the trust? Will a charitable remainder annuity trust lose its status as a charitable remainder trust because of the deemed contribution by its expatriating beneficiary? Charitable remainder annuity trusts are not permitted to accept additions.

(10) In the case of an interest in a pooled income fund within the meaning of Code Section 642(c) and in the case of a charitable lead trust, will the expatriate receive a charitable deduction for the deemed recontribution of assets back to the trust?

As suggested by the examples above, the Bill's provisions regarding the taxation of interests in trusts raise serious technical problems. The appropriate solution requires further study. In the case of an expatriating individual's interest in U.S. trusts, however, the best solution may simply be to impose a withholding tax on distributions to the expatriate to the extent such distributions are attributable to pre-expatriation income or gain of the trust.

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Last week Mr. Samuels concluded his testimony on H.R. 831 before the Senate Finance Committee by stating that: "Americans who avoid their tax responsibilities by expatriating should not be rewarded. Instead, they should be asked to pay tax that U.S. citizens will pay sooner or later."

I agree. They should be asked to pay. But a tax paid sooner is significantly more burdensome than one paid later. And, a tax paid on assets the expatriate may never receive creates an unconscionable burden. To ask an expatriate to assume a greater burden than a similarly situated citizen creates an unseemly "exit tax" that punishes U.S. citizens who make the politically unpopular choice of exercising their right to expatriate.

This concludes my prepared remarks. I would be happy to answer any questions.

Chairman JOHNSON. I thank you very much.

Mr. Stephan and Mr. Shay, you testified that this is fair. We have had a lot of testimony. This isn't going to fall fairly on people. I will put two questions to you. One is, why don't we write regulations about the current law? Why didn't we write forms? Why don't we know of all the people who decided to relinquish their citizenship last year, what the values of their assets are and who in fact might be affected by this?

And do you think it is good public policy to change a law in a way that will have both domestic and international ramifications with literally no information that is reportable about the 858 people in this category as reported by the Treasury.

Mr. SHAY. I will start with a response on the regulations. As I am sure you are aware, the resources of the Treasury Department and the IRS are limited. From my perspective, devoting resources to write regulations to a statute that is currently not effectively enforceable, no matter what regulation you write, is a waste of time. A regulation——

Chairman JOHNSON. Mr. Shay, let me talk about that just a minute. This law has been on the books 30 years. Don't you think it is not hard to write at least a regulation about forms to get the information so that anyone who makes this declaration will at least know? We have done that in other laws. This is not unique. This is not difficult.

We have asked for this kind of declaration in other circumstances and, to defend the Treasury on the basis that they can't write the regulations because the law is not enforceable, they do that all the time. They could have at least written regulations that ask for a declaration that says what the assets of these people are and so on and so forth so we would have the information.

Mr. SHAY. Madam Chair, I think earlier in the day there was a lot of comment regarding cost-benefit analysis. The only point I was making was applying a cost-benefit analysis to seek to write regulations that, even if fully enforced, would not yield a tax because of a deficiency in law or perhaps to impose a recordkeeping requirement that, again, would not have any effect under current law in terms of increased revenue. I could understand that from the Treasury perspective that would be a waste of time.

Chairman JOHNSON. Would you suggest, then, that Treasury might come to the same conclusion about the new law, because once the new law is written and the regulations are written, anyone in their right mind who is going to expatriate would expatriate before they hit the threshold and so it is not going to affect anything anyway?

Mr. SHAY. I agree that the new law would not apply unless there is gain in excess of $600,000 and, therefore, certainly some planning would revolve around whatever point you place that threshold.

I also agree that the new law would have some significant effect even without regulations. I think it does have some technical infirmities described in my testimony, but it certainly would have an immediate prophylactic effect starting from the proposed effective date of February 6.

If I may turn to another question you asked, which was the relationship of the proposal to treaties. Speaking only of income tax treaties, the administration proposal is less intrusive on the taxing rights of foreign governments than is current law. Under current law, the tax would be deferred until there is a disposition event. Typically—I mean, as the law is structured, that disposition event will always be at a time when the person selling is resident in another country.

Now, two things can occur. First, some of our older treaties would prevent the United States from collecting any tax on that sale in the case of long-term residents who move to another country. Second, some of our older treaties do not preserve the U.S. right to tax under existing section 877 because they have not been amended recently enough to pick up that rule.

Notwithstanding that the IRS has tried to impose that tax when somebody has gone to such a treaty country, the Tax Court has ruled against them; I think that the Tax Court decision is correct and would be upheld by other courts. So under current law, section 877 could not be applied effectively with respect to people who change their residency to certain other treaty countries.

There has also been, I think, a very correct reference to the possibility of there being a double tax, and I address that in my testimony. First, if, after the time a person has expatriated there is a tax under the administration proposal and a foreign country taxes that gain again, every income tax treaty that the United States has, except one, has an effective mutual agreement procedure that allows the two countries to settle issues of double taxation.

In my statement, I have strongly urged the Committee to urge the Treasury that, if this proposal passes in something like this present form, they reach mutual agreements with treaty partners to be sure that that expatriate gets full basis for the taxes paid on the gain that was accrued while in the United States so that other countries would not double tax that income.

There is no guarantee that this would occur. But I would also urge that you combine that with a recommendation to the Treasury that in negotiating all future treaties, that they try to include such a provision in the treaty itself so that there is not an issue of a possible disagreement under the mutual agreement procedure.

Chairman JOHNSON. May I clarify that point, Mr. Shay, because you didn't go through your testimony in detail. Are you saying that with all but one country, our tax treaties are such that they would allow a clarification of this point, though with some further negotiation?

Mr. SHAY. What these tax treaties have is an arrangement where the two tax authorities, when the same income has been taxed by both countries, sit down and they can discuss what the appropriate tax is in order to avoid double taxation. That is the purpose of the treaty.

If a taxpayer paid the tax upon exit, moved to a country with whom the United States does have an income tax treaty and were taxed again on the same gain, it would be entirely appropriate, and indeed I think we should encourage that taxpayer to go to the tax authority and initiate a procedure under that treaty.

The one problem with this is those two tax systems or administrators don't have to agree. This is not binding, although actually two of our newer treaties have binding arbitration clauses that would make it binding, but they are not implemented yet. But the objective of the tax authorities is to avoid double taxation and they should be able to resolve which country is appropriately taxing the gain.

Chairman JOHNSON. So in other words, all but one of our current treaties addresses this issue, though not in a binding way, and you would recommend that we renegotiate all of those treaties so that it is binding but that we make it binding in any future treaties?

Mr. SHAY. I agree. But if I may clarify just one point. I would recommend that we take as a negotiating position that this be binding in future treaties. But treaties include a lot of benefits and tradeoffs and I am not sure I would recommend that the United States have to have that, because you always have this procedure. The mutual agreement procedure has been criticized in the past for being slow, but the IRS has worked very hard on improving that procedure and I think that is a relief valve. It is not perfect, but it is an appropriate relief valve for the potential double taxation that could arise.

Chairman JOHNSON. But it is at the discretion of the other country.

Mr. SHAY. It is at the discretion of both countries, yes.

Chairman JOHNSON. Thank you.

Ms. McCaffrey, do you have any comment on that point?

Ms. MCCAFFREY. Well, I am not familiar with how that—those provisions have actually been used and I wonder if they have ever been used in a similar situation where the United States taxes income in 1 year and the other country isn't going to tax it until 10 years into the future.

I had thought the preferable way of dealing with this problem, and my remarks talk about this, is that our foreign credit, tax credit provision should be amended so as to allow the expatriate a refund in a year of later sale to the extent that she would have been permitted a foreign tax credit if she hadn't given up her citizenship.

Because what this provision is now doing is subjecting somebody to a greater tax who is in exactly the same position with one exception. If A and B both leave the United States with the same amount of appreciated assets and move to country X, and A gives up her citizenship and B doesn't, A is going to wind up paying a tax when she leaves, B won't.

Now, when they later sell the asset in the new country, A will pay a tax all over again and B will only pay one tax because the foreign tax credit provisions now in force will allow her a credit for her U.S. tax against the tax paid to the foreign jurisdiction.

Mr. SHAY. Just one point. I think, though, the credit would allow credit for the foreign tax against the U.S. tax.

Ms. MCCAFFREY. That is the point I am making. But in its current form, that won't work. So before we implement the expatriation tax, one of the kind of corresponding technical changes that ought to be made is a change to our foreign tax credit provisions

to allow a refund later on equal to the credit that would have been allowed if citizenship hadn't been relinquished.

Mr. SHAY. I respectfully disagree and I think this is a useful discussion. Precisely because under the foreign tax credit mechanism of U.S. law, the United States gives a credit for foreign tax imposed on the same gain that is taxed by the United States when it is considered foreign source income. So in other words, we are ceding our taxing right to the more senior taxing right, so to speak, of the other country. Frankly, when the tax is imposed at the time that that person is resident in the other country, that is not an unreasonable position. But I do think it ends up with the wrong result in cases where that other country taxes gain that has accrued up to the point of departure.

I think the United States should have the primary right to tax that gain. Indeed, under the mutual agreement procedure we just discussed, I think the right answer for the U.S. negotiators in that procedure is to say to the other country, we respect your right to tax this, but we think you should give a credit for the U.S. tax. That way the U.S. tax base is not eroded and I think you get the correct answer internationally.

Chairman JOHNSON. Is there any precedent for that?

Mr. SHAY. Yes. I don't know all of the competent authority cases because they are confidential, but I do know one competent authority case that deals with a very analogous point, and that has been made public. It is part of the record of the ratification of the U.S. treaty with Canada, and in that arrangement, the United States obtained a Canadian agreement to allow greater depreciation deductions to U.S. drillers, offshore drillers, who brought their rigs into the Canadian waters and then were taxed upon departure, in essence by recapturing of the depreciation in Canada, denying them when they were in Canada a full depreciation deduction.

The mechanics are very different than what we are talking about today, but the principles are precisely the same. It was used under the U.S.-Canadian treaty vis-a-vis their departure tax imposed on businesses, not individuals, to achieve a fair resolution of the taxing rights of the two countries.

Chairman JOHNSON. Ms. McCaffrey, has this approach been used generally in the taxation of foreign source income?

Ms. MCCAFFREY. Well, I am not aware of many instances where this kind of complex procedure is used for individuals who move from one country to the other, but I think this dialog is useful in that it points out that I think both of us agree, and most tax lawyers agree, that this legislation is creating a problem, a problem of double tax that ought to be cured, perhaps the way Mr. Shay suggests through treaties, perhaps the way I suggest with the modification of our foreign tax credit provision, but until it is clear that the system is going to avoid the double tax provision, I think the expatriation tax ought not to be passed.

This is a problem that needs to be worked out in advance. I don't think we should leave it up to the individuals in the future to negotiate their own tax breaks with the foreign governments in the foreign countries to which they move.

Chairman JOHNSON. Isn't one of your points that this not only creates a double tax problem, but it creates it over time? In other words, it might create it over a 10- or 15- or 20-year span of time.

Ms. MCCAFFREY. Part of the problem, of course, is the timing. In the normal course of events, the person that moves to country *x* and doesn't give up her citizenship doesn't have to pay this tax until an actual sale. But the person that moves to country *x* at exactly the same time has to pay the tax——

Chairman JOHNSON. So we have a choice. We create a better law that is more enforceable so that we can tax at the time of realization, whether you are here or there, or we have got this kind of situation where we have to solve the double taxation problem over time, and I would suggest that I am drawing the conclusion from this dialog between you that solving this double taxation problem will be administratively very complex.

Mr. SHAY. I think two points should be observed, though. One is, as I point out in my testimony, the current law provides no foreign tax credit whatsoever. It is completely deficient in that regard. So this is an issue that should be addressed.

Second, addressing it by waiting until realization weakens the claim of the United States to tax what I strongly urge the Committee to view as its fair share of the income as opposed to allowing France or Germany or the other country to tax it. Now, frankly, when the other country is the Bahamas, as it is in the case of at least one expatriate, I don't think we should worry too much.

Chairman JOHNSON. Would you consider quarantining of U.S. assets an appropriate response? Quarantining at the time of expatriation, and then you impose the tax at the time of realization, so you hold the asset.

Mr. SHAY. The advantage of quarantine, as I understand it, is that you are in essence creating a collection mechanism, but it doesn't surmount the problem that I have identified with respect to waiting for realization, because by that time the person has already entered the tax jurisdiction of another country. That creates the issue of double taxation.

Take this test, if I may suggest——

Chairman JOHNSON. But wouldn't it be easier to solve the problem of double taxation if you are dealing with it at the time of realization than if you are dealing with it at two different points, one at proclaimed realization and one of actual realization.

Mr. SHAY. Well, not necessarily, and for this reason: What the IRS has urged taxpayers to do in the transfer pricing world has been, at the time that a foreign country is claiming that the taxpayer has paid too little income to that country because, let's say, it has charged too large a royalty so there is a deduction in that country and the United States is getting all the income, the United States lags significantly in doing audits compared to some other countries, the IRS has said, when that country asserts a transfer pricing allocation, you tell us as soon as possible.

By the same token, under this regime, a taxpayer could notify the foreign government at the time of moving there in the first instance, the treaty authority, and try and set that procedure in place before selling the asset, so that that issue is something that is dealt with with certainty.

Second, I think we are overlooking here the fact that we are dealing with well-advised taxpayers, taxpayers who have gained in excess of $600,000, and I would be delighted to advise any of you or others as to how to take some self-help measures to avoid the double tax problem. To put it crudely, and I wouldn't advise a client to do this, but just for example, for illustration, if you were that concerned about the double taxation and you really did like the Bahamas as a place to sojourn for 1 or 2 years or whatever time it takes, you might move there for a period of time, sell your asset without tax, get current basis, and then move to the country where you want to live. This is not recommended.

What is recommended is to let people—hopefully people don't guide their lives by taxes such as we are describing here. But there is a potential for self-help that creative taxpayers can come up with.

Chairman JOHNSON. Wait 1 minute, Mr. Shay. Do I understand you to say, even if we changed the law, there would be ways to advise clients so that they could circumvent?

Mr. SHAY. Not so they could circumvent the U.S. tax, but so they could circumvent or avoid the double tax that could occur if they moved to another country. Two country's tax laws often don't work properly together.

Chairman JOHNSON. Is there any way we could focus on those whose purpose was tax avoidance and particularly those whose purpose was tax avoidance and who actually came back then and participated in our economic life quite extensively? Wouldn't it be possible to deal with that issue specifically rather than, in a sense, spreading such a broad net?

Mr. SHAY. It is possible, but I think the question has to be asked as follows: This tax only applies when an individual takes a strong affirmative step either to relinquish citizenship, which requires you to march in and file something with the State Department, or to give up your green card, give up your right to legal permanent resident status in the United States.

The simplest tax planning of all here to avoid these problems is to hold on to your citizenship and to hold on to your green card if you are going to come back. In that way, you are not going to have double taxation that isn't already relieved by our domestic law foreign tax credit mechanism, that isn't already relieved by treaties.

The point I am trying to make, Madam Chairman, is quite simple and that is we are dealing in a world where the tax is potentially so significant that I think individuals will take account of it.

I think the equities are in favor of adopting the administration proposal, recognizing that there are some technical changes that have to be made. I think the problems are in many respects more theoretical than real to a well-advised taxpayer. I do add that caveat, but that caveat I think is appropriate when you are restricting the gain to in excess of $600,000.

Chairman JOHNSON. Well, I am going to yield to my colleague, Mr. Hancock.

Mr. HANCOCK. I think, Mr. Shay, one of the comments that you made when you mentioned the word "fair share," and quite frankly, I think that is part of the problem that we have with our old tax law now, is that there is an awful lot of people that feel like, espe-

cially the investors, the ones that are making the personal sacrifices to investment of accumulated assets, now all of a sudden they feel like they are paying more than their fair share because of the way our tax law operates.

Ms. McCaffrey, you mentioned in your testimony, it indicates that you have been practicing tax law for approximately 25 years. Twenty-five years ago, or let's say 20 years ago, how often did you have anybody even talk to you about giving up their citizenship as a method to avoid or to postpone or to change their tax liability?

Ms. MCCAFFREY. Twenty years ago I wasn't having many people come to me to discuss that.

Mr. HANCOCK. What about 10 years ago?

Ms. MCCAFFREY. I would say it has been within the last 5 to 10 years.

Mr. HANCOCK. All right. Quite frankly since 1986, would you say?

Ms. MCCAFFREY. Over that period of time.

Mr. HANCOCK. When we got rid of the capital gains tax, and when we also went to a 28-percent tax and started getting rid of deductions, now we say, Well, our tax rate is actually less now, even though it is at 38 percent, it is less than it was at one time when it was up to 40 percent, but yet at that time you had deductions and now you don't have any deductions, except the interest on a residence. You know, that is about it.

Ms. MCCAFFREY. Those few clients of mine who have expressed an interest in perhaps expatriating for tax reasons, and I do emphasize that there have been very few, have been at least, equally, if not more concerned, with the estate tax burden than the income tax, although income tax is a concern.

But many of them, when they think about moving, think about moving to jurisdictions that pay—that have an income tax that in some cases are even higher than ours. It is the estate tax that is the problem.

Mr. HANCOCK. But Mr. Shay has indicated, and we respectfully disagree, that anybody that has assets over $600,000 is wealthy. I guess for a husband and wife that is 1.2 million. You know, 1.2 million wouldn't last very long in this day and age now, especially if you live 25 years, you may have trouble getting by. If you should have a widow who inherited $1,200,000, and if she happens to live to age 90, she is liable to become dependent on the government. If they are 65 now, 30 years from now I don't know what it is going to cost, and nobody else does, except I think you can just move your decimal point one place to the right and that will give you your cost of living 30 years from now. I am talking about what an average family or average person would have to have to stay in a retirement home, take the current process and just move the decimal point.

But it would appear to me that this statement that was made by the earlier panel, Mr. Norman, and I would like to get the response from this, or from each one of you: "If the policies of our country are driving our rich citizens to expatriate and encouraging the alien poor to emigrate, we have a problem." Now that was the statement made.

Well, let me ask the question. Does that exist? Is that what we are doing? Are we encouraging people with our tax laws to give up their citizenship and encouraging the alien poor to emigrate?

Mr. SHAY. If you are asking me whether current law, which creates the opportunity to renounce citizenship for the citizen and to expatriate for the long-term resident alien, if that creates the incentive, as professionals, we have to advise clients of that opportunity. Not everyone takes it, because many view the value of being a resident or a citizen of the United States to exceed the issue of taxes. But some do, and more will, I think, unless the issue is addressed, and the question is, do you want to let that continue or do you want to address the problem?

Mr. HANCOCK. But, in other words, I think everybody then pretty well agrees with what Mr. Shay said. However, should we address the problem by penalizing those people that have been successful rather than to make it beneficial for them to give up their citizenship, change the tax law to where it is beneficial to retain their citizenship, because they are the type of people that we need in this country.

Mr. STEPHAN. Congressman, I in my statement make the argument that a radical revision of our tax system would be attractive. I myself would favor replacing the income and the estate tax with a cash flow consumption tax. That is part of my good Republican credentials to make this assertion.

I do think that pressure for significant tax reform is thwarted by the continuation of loopholes in the law. I think given existing law, section 877 amounts to a loophole that 877(a) would block.

In other words, I am making the argument that it might be easier to move toward significant tax reform by taking away the opportunities to skirt a system that may be fundamentally flawed.

Mr. SHAY. I also would point out that while the tax lawyers at the two ends of the panel may be prescribing potentially differing approaches, I think I am hearing agreement that the current situation is unfortunate.

Ms. MCCAFFREY. I think that is right. I share your concern with the many problems in the tax system as a whole, but I am not sure that we should wait to cure this particular problem until we have a more rational overall tax system. This problem ought to be solved one way or the other. Mr. Shay and I simply disagree on the method to be used to solve it.

Mr. HANCOCK. But is this an opportunity to take a look at a more rational overall tax system.

Ms. MCCAFFREY. I agree.

Mr. HANCOCK. For instance, Stanford Hoover Institute's flat tax that they are suggesting, is it time we address that? You all are tax practitioners. Can we continue to what I call compound the felony by writing more regulations or tax law?

Ms. MCCAFFREY. No. I think it is time to take a hard look at the system. Its complexity has grown to the extreme that we have problems of this sort and when we try to cure a particular problem with a Band-Aid in one area, we find that we are creating two or three other problems in another area.

Mr. HANCOCK. Well, as a personal note I met with my CPA yesterday afternoon at 1 o'clock. He had his computer, I had my com-

puter, and along about 4 or 5 o'clock we finally figured out that maybe we were close to getting my income tax ready to file for 1994.

You know, I mean something is wrong, something is wrong when it takes that amount of time, and two computers, you know, when you have to carry your portable over to your CPA to look up information and still not even know for sure whether you are right or wrong.

Thank you, Madam Chairman.

Chairman JOHNSON. Ms. McCaffrey, am I correct in concluding from your testimony that you believe we can strengthen the current law and correct the problems in the current law to deal with this problem more effectively than adapting the administration's proposal?

Ms. MCCAFFREY. That is my testimony; that is what I believe. I believe section 877 can be strengthened to solve most of the problems. You are not going to wind up with a perfect system, but I don't think what the administration is proposing is going to be a perfect system either. I think over a 10-year period, if we are taxing U.S. source income, that the United States will wind up taxing most of what is appropriate for it to tax.

Chairman JOHNSON. Mr. Shay, would you agree that one of the problems in the current proposal is that while you can defer payment, you must make it and you accrue interest at a rate that could result in your paying more than the value of the asset in taxes?

Mr. SHAY. I guess I don't view that as much of a problem as others do because I think in part it is the price for taxing the correct amount and for assuring that the United States rather than another country gets to tax its fair share.

Chairman JOHNSON. Of course, there is a very significant difference here. We are forcing taxation on assets that must either be sold at a time when it is unfavorable and therefore, you are going to get an undervaluing of it, or in the trust area, aren't we forcing a cash obligation that there may not be any way to gain the cash to make good on? I mean, isn't that true? Isn't that one of the possibilities under this law?

Then you would have no choice but to ask for deferral, have no choice but to pay interest and have no choice in the end but to be liable for something greater than the assets. Correct me if I'm wrong, Ms. McCaffrey.

Ms. MCCAFFREY. I am glad you are turning your attention to the trust aspects of this proposal, because I think that those aspects are the most seriously flawed of all of the proposals, because what the proposal does is impose a tax on assets that a beneficiary has no right to have, and in the normal course of events may never receive.

There is an example in my prepared remarks that illustrates it, yet in order to give up an individual's citizenship, she is going to have to pay a tax on her deemed share of assets inside a trust. That seems to me to be very bad tax policy.

Mr. SHAY. I don't want to comment on the trust aspects of this. I specifically reserve technical comment on that in my testimony.

Chairman JOHNSON. Do you think there are problems in the trust aspects?

Mr. SHAY. I have not formed a strong enough view to express a view one way or the other which is what I said in my prepared testimony. I think it is a complex area, and actually, I defer to my colleague on my right as being far more expert in that area than I am.

But in response to your question, I want to again remind ourselves that the act that we are talking about of renouncing citizenship or of passing in your green card is one that the individual himself or herself will affirmatively take. So taxes will come into play for that act, if you think that you are better off by waiting, then you may pay another year's U.S. income tax to wait for the proposal.

Chairman JOHNSON. Of course then you do get back to Rabbi Moline's problem.

Mr. SHAY. But that doesn't affect your ability to leave.

Chairman JOHNSON. Even if you are paying taxes, Mr. Shay, it surely does affect your ability to leave. I mean, at least be honest about what we are talking about. I don't disagree you made some excellent points, but we are going to impose a tax. That for many will mean that you cannot exit, period. I mean, we ought to be honest about that.

Mr. SHAY. I am having trouble.

Chairman JOHNSON. You could give examples from your experience of the trust area of taxes that can be imposed that there will be no way that anyone can sell anything or do anything to realize that tax to pay. So you cannot by definition leave.

I mean, that is what we are doing here. That is not all of what we are doing here. And there is the problem that we all agree is there, that we do not want people to be able to renounce their citizenship for the purposes of evading taxes. That we are in agreement about.

But not to recognize that there is a downside here that is so significant that we are going to actually deny our own citizens the right to do something that in many other instances we have declared a sort of fundamental human right, the implications of that are very significant.

Mr. STEPHAN. Congresswoman, if I could jump in there, we are not addressing leaving in this bill.

Chairman JOHNSON. Well, we are making leaving impossible or possible.

Mr. STEPHAN. No, ma'am. Someone can become a permanent resident overseas and not be affected by this law. This law only applies to expatriation.

Mr. SHAY. Madam Chairman, I would agree that it is incumbent on us, if this proposal is going to move forward, to address the trust issues in a manner that would not have the outcome that you are describing. And I am frankly skeptical that it is beyond the realm of our imagination either in the bar or elsewhere, to come up with an approach that would avoid that result.

Chairman JOHNSON. Well, we will certainly relay that information to the conference committee, that there are problems in this bill that really have to be addressed before they bring it out of con-

ference committee, or it will have some very negative impact. My understanding is that it will be out of the conference committee in a very few days.

I would ask you, do you think the problems in this bill can be corrected in the next 3 or 4 days? I open that to all the panel.

Ms. MCCAFFREY. I think it is going to take much more than 2 or 3 days. I think that the people who are drafting the legislation and the corrective legislation need to draw on the resources of lawyers in the various bar groups across the country in order to help deal with this problem.

I am a member of the committee of the N.Y. State Bar Association tax section that has begun to study this a week or so ago, and we expect that we are going to have a report that will make some suggestions as to how the bill can be improved within the next several weeks. Other bar associations are conducting similar studies, and I think the information and the reports that come out as a result of that can be helpful to you to come up with a good proposal, one that could be passed maybe later this year, but not within the next several days.

Chairman JOHNSON. Thank you. We will be interested in those reports.

I do thank you all for your comments on, as I say, very short notice. Our notice was short as well as yours was short, and I think perhaps with your help, we perhaps can make rational sense of all of this.

Thank you very much.

Mr. SHAY. Thank you for your attention.

Chairman JOHNSON. Thank you.

[Whereupon, at 3:15 p.m., the hearing was adjourned.]

[A submission for the record follows:]

STATEMENT OF
JOHN E. CHAPOTON
SUBMITTED TO THE
SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

March 27, 1995

I am pleased to present our views on the proposal to tax U.S. citizens upon expatriation. I am the Managing Partner of the Washington Office of Vinson and Elkins L.L.P., a law firm with a large international tax practice.

The principal purpose of my testimony is to make certain the Committee is aware of serious technical difficulties in the application of the expatriation tax to beneficiaries of trusts. We represent a U.S. trust the beneficiaries of which would be adversely affected by the proposed legislation in what we think are unintended ways. We have discussed these problems with the Committee staffs, the Joint Committee staff, and the Treasury Department's Office of International Tax Counsel, and I believe they are considering what, if any, changes in the proposal might be appropriate in response. The facts with respect to the trust are set out, in simplified form, below.

I would make three preliminary comments about the proposal you are considering before going into our specific problems. First, I would point out that the Code already contains provisions designed specifically to prevent expatriation by a U.S. citizen for the purpose of avoiding U.S. tax. It is obvious that the Treasury Department believes these provisions to be inadequate, and the Administration thus has proposed an "exit tax" as a substitute for existing law. The exit tax is a wholly new type of tax, without precedent in the Internal Revenue Code. That is a bold and unproven course to follow. The difficulty of designing an entirely new scheme of taxation in this area is illustrated by the many problems that have been identified in just a brief time in attempting to apply this new scheme to trust beneficiaries. It is likely there are other, undiscovered difficulties in the application of such a provision in other fact situations will emerge. It might be prudent to consider amending the provisions of existing law to make them work more effectively, rather than to adopt immediately such a radical new approach. We make some suggestions toward that end at the conclusion of this statement.

Secondly, the proposed exit tax, if enacted, would often be a major factor in an individual's decision to relinquish U.S. citizenship (from the U.S. to the country of the individual's birth or where he or she was raised and may now live, for example). The potential of a tax burden on expatriation or change in residency also could be a significant factor to a citizen of another country who is contemplating emigrating to the U.S. Only two or three other countries now attempt to impose such a tax, and even in those few cases the countries concerned modify the tax to make its application less stringent than the provision adopted by the Finance Committee. If the United States adopts an exit tax, it is quite possible (even likely) that such taxes will become the international norm. The Committee should consider carefully whether it wants all countries to impose these types of taxes on individuals who change citizenship, and if so whether the United States should adopt some sort of stepped-up basis rule for immigrants who enter this country, to prevent U.S. taxation of the gain in assets they bring with them that was accrued before they became U.S. citizens.

My third and final preliminary comment is to point out that the exit tax would, of course, be imposed without the realization of any income by the taxpayer. That is virtually unheard of in our income tax system; the only arguable precedents I can think of relate to so-called "section 1256 contracts" (where a mark-to-market rule was adopted to deal with specific tax avoidance problems through the use of straddles) and to mark-to-market tax rules for professional securities dealers, who already keep their books under a mark-to-mark system and

whose assets are readily convertible into cash. The exit tax would thus not only impose a tax at a much earlier point in time than would normally be the case (which is in itself a penalty), but would necessitate collection by the IRS when there may be no liquid assets with which to pay the tax, and in some cases (such as the case of the trust beneficiary described below) when the taxpayer has no access to the assets the gain on which is being taxed. These problems can be ameliorated, but not solved entirely, by deferral in collection of the tax. The important point to realize is that taxing appreciation in the assets of individuals before it is realized is a big step, and a step that unavoidably causes problems in application of the tax.

Problems in Application of the Exit Tax to Trusts

The beneficiary of a trust who might contemplate relinquishing his or her U.S. citizenship would face special problems under the provision proposed by the Treasury and under the version of the proposal adopted by the Finance Committee. The difficulties are principally a result of the fact that a trust beneficiary ordinarily has no access to the assets of the trust even though he or she has a beneficial interest in those assets. It does not at all follow that because a person is named a contingent beneficiary in a trust, even a large trust, he or she has any assets apart from that interest. Family estate planning that concentrates family assets in a trust often leads to the result that, though the trust may grow large over the years, subsequent generations of family members have no significant personal assets. The problem is compounded in the case of remainder beneficiaries because it may be many years before they receive any income or assets from the trust; and the problem is further compounded if, as is often the case, the remainderman's interest is contingent, and thus will only be realized if he or she outlives the life beneficiary.

Even in the seemingly simple case of a life beneficiary who is receiving distributions of income from the trust, the exit tax would have surprising consequences. If that individual expatriates, the gain on the trust's assets would be taxed to him or her even though all the capital of the trust, including all appreciation, will go not to that individual but to the remaindermen who ultimately receive the trust's assets. Further, the income beneficiary would not apparently obtain any step-up in basis.

Facts

The trust we represent was created many years ago. The trust instrument requires that all trust income be paid to a single beneficiary for his life, and upon his death and the death of his siblings, the trust terminates. The assets of the trust are then to be distributed to the children of the income beneficiary who are alive at that time. If any child of the income beneficiary is deceased, the assets of the trust are to be distributed to his or her children.

The trustees have no discretion to pay any principal to the income beneficiary or the contingent remaindermen (the children and grandchildren of the income beneficiary). Furthermore, the trust contains a strict spendthrift provision, which prevents any beneficiary from selling, assigning, or otherwise anticipating his or her beneficial interest in any way; for example, a beneficiary could not use a beneficial interest in the trust as collateral for a loan.

The income beneficiary and several of the remaindermen live abroad. In fact, some were born abroad and have never lived in the United States. The income beneficiary has lived in a high tax Western European country for more than 20 years, never even visiting the United States. He obviously will not realize a U.S. income tax benefit if he expatriates, but he is considering doing so for personal reasons. If the exit tax were adopted in its present form, the U.S. tax penalty, as described below, would be severe and, indeed, prohibitive in the case of the contingent remaindermen because it would significantly exceed the value of their other assets.

The Income Beneficiary

If the income beneficiary should expatriate, he would have tax liability determined by using the trust's basis in the assets "attributable" to his income interest. Presumably, the interest attributed to him would be based on the value of his life expectancy relative to the total value

of trust assets. Under the exit tax provision adopted by the Finance Committee, the following problems would be presented.

- The income beneficiary will pay tax on a portion of the unrealized capital gains in the trust's assets even though *he can never receive any portion of those capital gains.*

- The income beneficiary *will not have access to either trust assets or income in order to pay the tax* because the income beneficiary cannot anticipate his future income from the trust (which would stop tomorrow if he were to die).

- Certain U.S. source fixed or determinable income of the trust paid to the income beneficiary would be subject to U.S. withholding taxes, apparently with *no basis adjustment to reflect the fact he had paid a full tax* on part of the value of his income interest. It is unclear who, if anyone, would ever receive the benefit of the basis created by the deemed sale of trust assets.

The Contingent Remainder Beneficiaries

If a child of the income beneficiary expatriates, he or she will have a tax liability based on the unrealized capital gains on the proportionate share of trust assets attributed to his or her contingent remainder interest, as if the trustee has sold those assets and distributed the proceeds to the beneficiary.

- On an actuarial basis, it will be more than 22 years before any remainderman can expect to receive the assets on which he or she will pay a tax, and then only if surviving. Furthermore, the grandchildren of the income beneficiary have an even more remote interest they are not likely ever to receive (their grandparent would have to survive their parent). *Such interests can be extremely remote* but nevertheless can be subject to the tax as proposed.

- *A remainderman cannot reach trust assets to pay the tax*, so as in the case of the income beneficiary, a remainderman would have to pay tax out of other assets, if any. If a remainderman did not have assets adequate to pay the tax (and in the case posited, none of them do), *the provision would prevent him or her from expatriating.*

- A remainderman's interest is contingent, either on surviving the income beneficiary (in the case of a child of the income beneficiary), or on his or her parent not surviving the grandparent (in the case of a grandchild of the income beneficiary). *A remainderman would be required to pay the exit tax on gain in assets he or she may never receive.*

- A remainderman may obtain no basis in trust assets for foreign tax purposes, thus *potentially subjecting gains to international double taxation.*

Proposed Solutions

We think these problems can be ameliorated, if not solved altogether, by the following amendments to the provision adopted by the Finance Committee.

Income Beneficiary

At the election of the income beneficiary, no sale of assets should be deemed to have occurred. Instead, for some period (10 years, for example) the trust income would continue to be taxable to the income beneficiary as received, in the same manner as if he or she had not expatriated.

Remainder Beneficiaries

With respect to remainder beneficiaries of trusts, the following rules should be adopted:

a. De minimis rule. The interest should not be taxed if it is so remote as to represent an insubstantial proportion of the total interest in the trust determined on an actuarial basis (for example, 10 percent).

b. 1. Trust-level tax. Any tax with respect to a remainderman should be imposed on the trust, which has the assets with which to pay the tax, rather than on the income and remainder beneficiaries. The trustees can adjust trust interests and basis to take such payments into account to properly allocate the burden and benefit of the tax under many applicable local probate laws. *See, e.g., Estate of Warms,* 140 N.Y. Supp.2d 169, 171 (1995); *Estate of Bixby,* 140 Cal. App.2d 326, 388 P.2d 68 (1956).

2. Deferral of tax. Alternatively, a remainder beneficiary could be allowed to defer the payment of the tax until the interest vests and is distributed. The tax should continue to be calculated based on the gain with respect to the beneficiary's share of trust assets at the time of expatriation because any subsequent appreciation in value is accumulated at a time when the beneficiary no longer enjoys the protection of U.S. citizenship and U.S. law.

Furthermore, no interest should be assessed on the deferral because the exit tax is imposed upon unrealized gains, in advance of the time when those gains would normally be taxed. Deferral of tax until realization does not ordinarily carry with it an interest charge, and it should not in this case.

c. Refund procedure. Any tax paid with respect to a contingent remainderman should be refundable to the trust in the event the trust terminates without any interest vesting in that remainderman. Alternatively, the exit tax should not be due with respect to a contingent remainderman unless and until the remainderman becomes entitled to trust assets.

Even if these solutions were adopted, there would be the potential for double taxation of gain on trust assets if the exit tax is applies to beneficial interests in trusts. There does not appear to be any way other than renegotiation of international tax treaties to address this problem.

Alternative Approach

The unforeseeable technical and policy problems that might flow from the adoption of an exit tax in such a short time frame might suggest that a more viable alternative would be to make section 877 more effective. For example, consideration might be given to one or more of the following with respect to a U.S taxpayer who wishes to expatriate:

a. The taxpayer could be required to file with the IRS a complete financial statement, which would include a description of all assets.

b. The taxpayer could be required to agree to file annual information returns for a 10-year period following expatriation.

c. The taxpayer could be required to grant a lien on U.S. property or provide other acceptable security to assure payment of any future U.S. tax liability.

d. The taxpayer could be required to appoint a U.S. agent for the purpose of service of process.

Conclusion

We appreciate the Committee's consideration of the problems the tax on expatriation would cause for beneficiaries of trusts. We hope you agree that these consequences are undesirable and unintended.

EXPIRING TAX PROVISIONS

HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

OF THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDRED FOURTH CONGRESS

FIRST SESSION

MAY 9, 1995

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SUBMISSIONS FOR THE RECORD

EXPIRING TAX PROVISIONS

TUESDAY, MAY 9, 1995

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT,
Washington, DC.

The Subcommittee met, pursuant to notice, at 10:15 a.m., in room 1100, Longworth House Office Building, Hon. Nancy L. Johnson (Chairman of the Subcommittee) presiding.

[The advisory announcing the hearing follows:]

ADVISORY 26-186

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON OVERSIGHT

FOR IMMEDIATE RELEASE
April 19, 1995
No. OV-6

CONTACT: (202) 225-1721

JOHNSON ANNOUNCES HEARING ON THE TARGETED JOBS TAX CREDIT, THE EXCLUSION FOR EMPLOYER-PROVIDED EDUCATIONAL ASSISTANCE, THE ORPHAN DRUG CREDIT AND OTHER TEMPORARY TAX PROVISIONS

Congresswoman Nancy L. Johnson (R-CT), Chairman, Subcommittee on Oversight of the Committee on Ways and Means, today announced that the Subcommittee will hold a hearing to examine issues relating to several recently expired provisions of the tax laws, including the targeted jobs tax credit (TJTC), the exclusion for employer-provided educational assistance, the tax credit for orphan drug clinical testing expenses, and the special rule for certain contributions of qualified appreciated stock to private foundations, as well as other tax provisions scheduled to expire. **The hearing will take place on Tuesday, May 9, 1995, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 10:00 a.m.**

BACKGROUND:

Targeted Jobs Tax Credit. Prior to January 1, 1995, certain employers could claim a credit based on qualifying wages paid to individuals from several targeted groups (Code section 51). The targeted groups consisted of individuals who generally were recipients of payments under means-tested transfer programs, economically disadvantaged, or disabled. The credit was equal to 40 percent of up to $6,000 of first-year wages paid to a certified member of a targeted group. Thus, the maximum credit generally was $2,400 per individual. With respect to economically disadvantaged summer youth employees, the credit was equal to 40 percent of up to $3,000 of wages, for a maximum credit of $1,200. The credit expired for individuals who began work for an employer after December 31, 1994.

Exclusion for Employer-Provided Educational Assistance. Prior to January 1, 1995, an employee's gross income and wages for income and employment tax purposes did not include amounts paid or incurred by the employer for educational assistance provided to the employee if such amounts were paid or incurred pursuant to an educational assistance program that met certain requirements (Code section 127). This exclusion, which expired with respect to amounts paid after December 31, 1994, was limited to $5,250 of educational assistance with respect to an individual during a calendar year. In the absence of the exclusion, for purposes of income and employment taxes, an employee generally is required to include in income and wages the value of educational assistance provided by the employer unless the cost of such assistance qualifies as a deductible job-related expense of the employee.

Tax Credit for Orphan Drug Clinical Testing Expenses. The orphan drug credit (Code section 28) provided a 50-percent nonrefundable tax credit for a taxpayer's qualified clinical testing expenses paid or incurred in the testing of certain drugs for rare diseases, generally referred to as "orphan drugs." Qualified testing expenses are costs incurred to test an orphan drug after the drug has been approved for human testing by the Food and Drug Administration (FDA) but before the drug has been approved for sale by the FDA. The orphan drug credit expired after December 31, 1994.

Gifts of Publicly-Traded Stock to Private Foundations. Prior to January 1, 1995, the deduction allowable for charitable contributions to private nonoperating foundations of certain readily marketable stock was the full fair market value of the stock on the date of contribution (Code section 170 (e)(5)). Thus, for donations made during the period prior law was applicable (July 19, 1984, through December 31, 1994), the rule generally applicable to donations of capital-gain property to nonoperating foundations (sec. 170(e)(1)(B)(ii)) -- which generally limits the deductible amount to the asset's cost -- did not apply to contributions of such stock.

Federal Unemployment Tax Act (FUTA) Exemption for H-2A Agricultural Workers. Under a program administered by the Immigration and Naturalization Service, aliens are admitted to the U.S. on a temporary basis to perform agricultural labor. Prior to January 1, 1995, this agricultural labor was exempt for purposes of FUTA employment taxes (Code section 3306(c)(l)).

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Production Tax Credit for Nonconventional Fuels. Under current law, certain nonconventional fuels are eligible for a production credit equal to $3 per barrel or Btu oil barrel equivalent (Code section 29). The Energy Policy Act of 1992 extended the credit, for gas produced from biomass or synthetic coal fuels. These fuels must be produced domestically from a facility placed in service before January 1, 1997, pursuant to a written binding contract in effect before January 1, 1996. Fuels produced from facilities which satisfy the binding contract rule may qualify for the credit if sold before January 1, 2008.

Transportation Fuels Tax Exemption for Aviation Jet Fuel. The Omnibus Budget Reconciliation Act of 1993 generally imposed a 4.3 cents per gallon excise tax on transportation fuels effective October 1, 1993. However, a two-year delay from the transportation tax was provided for gasoline and jet fuels used in commercial aviation. Thus, on October 1, 1995, the current commercial aviation fuels tax exemption will expire. Revenues generated by the transportation excise tax are retained in the General Fund of the Treasury.

DETAILS FOR SUBMISSIONS OF REQUESTS TO BE HEARD:

Requests to be heard at the hearing must be made by telephone to Traci Altman or Bradley Schreiber at (202) 225-1721 no later than the close of business, Wednesday, April 26, 1995. The telephone request should be followed by a formal written request to Phillip D. Moseley, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. The staff of the Subcommittee on Oversight will notify by telephone those scheduled to appear as soon as possible after the filing deadline. Any questions concerning a scheduled appearance should be directed to the Subcommittee staff at (202) 225-7601.

In view of the limited time available to hear witnesses, the Subcommittee may not be able to accommodate all requests to be heard. Those persons and organizations not scheduled for an oral appearance are encouraged to submit written statements for the record of the hearing. All persons requesting to be heard, whether they are scheduled for oral testimony or not, will be notified as soon as possible after the filing deadline. Witnesses scheduled to present oral testimony are required to summarize briefly their written statements in no more than five minutes. **THE FIVE MINUTE RULE WILL BE STRICTLY ENFORCED. The full written statement of each witness will be included in the printed record.**

In order to assure the most productive use of the limited amount of time available to question witnesses, all witnesses scheduled to appear before the Subcommittee are required to submit 200 copies of their prepared statements for review by Members prior to the hearing. **Testimony should arrive at the Subcommittee on Oversight office, room 1136 Longworth House Office Building, no later than 5:00 p.m. on Friday, May 5, 1995.** Failure to do so may result in the witness being denied the opportunity to testify in person.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE:

Any person or organization wishing to submit a written statement for the printed record of the hearing should submit at least six (6) copies of their statement, with their address and date of hearing noted, by the close of business, Tuesday, May 23, 1995, to Phillip D. Moseley, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements wish to have their statements distributed to the press and interested public at the hearing, they may deliver 200 additional copies for this purpose to the Subcommittee on Oversight office, room 1136 Longworth House Office Building, at least one hour before the hearing begins.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages including attachments.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. A witness appearing at a public hearing, or submitting a statement for the record of a public hearing, or submitting written comments in response to a published request for comments by the Committee, must include on his statement or submission a list of all clients, persons, or organizations on whose behalf the witness appears.

4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and the public during the course of a public hearing may be submitted in other forms.

Note: All Committee advisories and news releases are now available over the Internet at 'GOPHER.HOUSE.GOV' under 'HOUSE COMMITTEE INFORMATION'.

Chairman JOHNSON. Good morning.

We have a long day ahead of us, so I am going to be brief, and I will encourage my colleagues and the witnesses to be sensitive to the difficulty of examining seven provisions of tax policy in a single day and to observe the limitations of our time.

Perhaps someone should call the National Enquirer, because when I first looked over the list of expiring provisions we are considering today, I could have sworn I saw Elvis. [Laughter.]

Just to give you some idea of how long we have been temporarily extending some of these provisions, in 1978 the Shah was in power in Iran, Brezhnev was in power in the Soviet Union, a letter could be mailed for 15 cents, "Annie Hall" won an Oscar, and the best-selling album of the year was "Saturday Night Fever." Disco may be gone, but the expiring provisions, like Elvis, live on.

All of these provisions have some merit. In fact, I have sponsored or cosponsored legislation to extend many of them. However, it is not clear that we can afford to extend them all. It is indeed timely and appropriate to examine these provisions to see how well they are working, to determine which of them may need fine-tuning, and to decide whether some of them have outlived their usefulness.

It is my hope that the 104th Congress will determine which of these provisions have sufficient merit to justify enacting them permanently and which we can do without. We do not have a limitless list of loophole closers. Every time we extend expiring provisions, we have to make up the revenue somewhere else.

If we were to make permanent each of the seven provisions we are examining today, along with the two provisions we will be considering tomorrow, the R&E credit and the research expense allocation rule, the 5-year cost to the Treasury would be nearly $20 billion. Of course, budget policy may dictate resorting to temporary extensions, something which provides less certainty and a greater administrative burden for taxpayers and the service alike. In any event, with the budget deficit as a backdrop, we do not have the luxury of ignoring the costs associated with extending these provisions.

I welcome today our witnesses and I thank them for joining us.

With that, I will yield to my Ranking Member, Mr. Matsui.

Mr. MATSUI. I would like to thank Chairwoman Johnson for putting on these hearings. I think they are extremely important, particularly in light of the fact that this year we would like to make certain provisions permanent, and I would like to associate myself with her remarks in terms of the issue of permanency.

Let me just make a couple of very brief observations about the extension of these provisions. I would hope, as Chairwoman Johnson has indicated, that we do make these provisions permanent, for two reasons: One, obviously, we do not get a chance to really prioritize. As these provisions come up, we reach a deadline, we have very little opportunity to either make changes or prioritize and look at others and drop some, because they all tend to go together. Of course, that is not really a good way to legislate.

The second reason is that we need to create certainty. We need to create certainty for those that use this credit. The R&E credit is a great example. Many of the business leaders, high-tech companies and others that use this credit have always assumed that they

were going to be extended, but when we reach a deadline, uncertainty occurs. They might be preparing their fiscal budget for the next 2 or 3 years, and it does create a great deal of difficulty and problems.

Certainly, the issue of financing, as the Chairwoman indicated, is always there that we have to deal with. Nevertheless, it is my hope that we will be able to make these provisions or at least some of these provisions permanent in this Congress, so that we will not have to deal with this as we have in the past.

I would like to also indicate that there are four provisions that I would like to see extended permanently. I will not mention them, but I am going to be working on these with the Chair, with the notion that we do make, for example, the research experimentation credit, the allocation of research experimentation credit, and the allocation of research experimentation expenses and a number of others permanent.

With that, if time permits, I would like to yield to Mr. Levin from Michigan.

Chairman JOHNSON. Do any other Members have an opening statement?

Mr. Levin.

Mr. LEVIN. Madam Chairwoman, I would ask that my opening statement be put in the record.

Chairman JOHNSON. Without objection.

Mr. LEVIN. Let me just briefly say a few things. I would like to move along, because our colleagues have been patient, and there are many more witnesses to come.

First of all, I would like to commend you for this hearing. It will be lengthy, but I very much agree with your insistence that we do this thoroughly.

Let me just say a word about employer provided education assistance and its importance, section 127. I think sometimes we underestimate the impact of the Code on the overall competitiveness of this country. I feel very deeply about its extension, and that is why the first day of the session, Mr. Shaw and I introduced legislation to reinstate and permanently extend it.

This provision has been a win-win provision for this country, for employers and employees alike. It has helped thousands of people to be retrained, move up the ladder of success to their benefit and the benefit of their companies.

In my statement, I refer to a gentleman by the name of Earl Hartman who worked at the GM Tech Center in Warren, Michigan, for 29 years. He had to quit school at the beginning of his employment to help raise his family. Now, he has been able to return to college and become a computer programmer.

The vast majority of people who benefit from this program, about 70 percent, earn less than $30,000 a year. Without this credit, without this exemption, they would not be able to continue. This deduction, to state the provisions technically correct, is vital for employees and employers alike. Together it provides really the tools so that they can be on the cutting edge of tomorrow's developments economically.

My colleagues, I hope very much that when we end this hearing, we will conclude that this is a vital provision and that we should permanently extend it. I would like to put in the record a statement I received today from the University of Michigan. I will leave the rest of my statement for the record.

Thank you very much.

[The opening statement follows:]

SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS

REMARKS ON EXPIRING PROVISIONS

BY

THE HONORABLE SANDER LEVIN

MAY 9, 1995

Madam Chairwoman, I would like to thank you for calling these hearings. The issue of renewing many of these provisions has continued to be a thorn in the side of everyone involved. I believe that they will put us on the road to removing this thorn, so that we can stop coming back again and again to revisit the same old issues as this process has been particularly burdensome for all of those involved.

I would like to call attention to the provision which allows an important exemption for employer-provided education assistance. On the first day of this Congress, Representative Clay Shaw and I introduced a bill that would reinstate and permanently extend this provision in order to help the millions of workers who are not being taxed on their tuition.

This provision is a win-win proposal for employers and employees alike. Companies use it to retrain workers whose jobs or skills have become obsolete. Workers use it as a way to improve their education, to move up the ladder of success, and to stay ahead of new technologies. Failing to extend it will send the wrong message to employers and employees about the importance of education.

The importance of this exemption can be best illustrated by Earl Hartman, who worked at the GM Tech Center in Warren, Michigan, for 29 years. After having to quit school to raise a family, Mr. Hartman has been able to return to college and become a computer programmer. He is even now working toward getting his Master's degree in science and technology.

Since the creation of employee educational assistance programs, millions of workers, much like Earl Hartman, have benefited by using them as a means to upgrade skills and keep up to speed with new competitive, technological, industrial developments.

Seventy percent of those who us this training earn less than $30,000 a year. Many of who have contacted me about this exemption say they will not be able to continue their education without this deduction because they simply cannot afford to pay the taxes that have been tacked onto their tuition.

The people who use this provision will be tomorrow's engineers, accountants, computer specialists, in short, tomorrow's cutting edge. This exemption is important to people who live in suburban areas, much like the one I represent. They know first-hand that staying on the cutting edge of new skills is the only way to protect themselves in our rapidly changing economy.

Since "employee educational assistance" began, millions of workers have used them to upgrade their skills and keep up to speed with new technological and industrial developments.

I hope that by the end of today's hearing the members of this Subcommittee will realize the importance of this exemption to employers, to employee's, and to the nation as a whole.

Chairman JOHNSON. Thank you, Mr. Levin.
Mr. Houghton.

STATEMENT OF HON. AMO HOUGHTON, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEW YORK

Mr. HOUGHTON. Thank you, Madam Chairman.

Could I just make a comment. It is not easy to hear your voices. I do not know what happens to the back of the room, but maybe if they could put up the volume a little bit, it would be great.

Chairman JOHNSON. We will tell you, as we so often do, to get close to the microphone.

Mr. HOUGHTON. Maybe I will be too loud and compensate for that.

Mr. LEVIN. You are never too loud.

Mr. HOUGHTON. I would like to thank you for letting me be here. I am here on the concept of a targeted jobs tax credit. It is good to be back at my old Committee. I will try to be brief, because you have lots of witnesses and many panels.

The reason I am here, Madam Chairman, along with Mr. Rangel, is to tell you of my plans to introduce legislation within the next several weeks to reinstate, in effect, a reform of the new and different targeted jobs tax credit. This credit is the same old plan. The concept is the same old plan as the one which was started in 1978 and which ended in December of last year. The rules are entirely different.

Why are we doing this? For one simple reason, in the House, our hopes are to change the welfare program dramatically, and that means to make it essential that people, where they are able, move into the job market. The concept is good and our intentions are admirable, but there is one missing piece. Where are the jobs?

It is easy to sort of replan welfare, but to make it work, there must be receivers out there to offer work. These things just do not happen out of thin air. Somebody has to have an overwhelming need, a big heart or an incentive to take on people who usually have a very low skill base. The job market, as you know, is moving away from that type of job category.

So enter TJTC, the targeted jobs tax credit. Two million people leave welfare every year, one million because they have found jobs, but those jobs are usually temporary, and so the charade goes on. They move into a job and out of a job, into a job and out of a job.

Under the House welfare reform bill, after 5 years, we could have over 500,000 people a year going off welfare forever, and even sooner, if the States make special procedures on this. Where will these people go, into the private sector? Sure, to some degree. But let us remember that the McDonald's and the service stations and the Pizza Huts and people like that have enormous profit squeeze on them. The margin is very thin, and so many cannot take a chance.

Also, as you know, the larger corporations need sure-fire skilled and dependable people for a variety of different reasons. The private sector can and will absorb some of its own, but that will not take care of the more risky cases. Here is where the tax incentives come in. In effect, for up to a year, with varying tax incentives, you can economically justify taking a chance on someone. If you win, you have saved a life and trained a good employee and put that

person back into a self-respecting job in the work force. If you lose, you have not lost an arm and a leg in the process.

There are arguments against this, particularly the programs which expired on December 31 of last year. We have tried it and it did not work. The cost to the government was a lot of money, and over 90 percent of the people would have been employed anyway, and that is true. The concept was good and the mechanics were bad.

What have we done to fix those? We have tried to take a look at various aspects of those mechanics. For example, rather than hiring people and then shoving them into this particular category in order to get the tax incentives, there is a very careful precertification and clearing process that goes on.

Another criticism is employees do not stay on the job. You get your incentive, the employer gets the benefit and then the job is over with. We have sort of backloaded credits to give incentive to the employer to keep the employee on the job longer.

Madam Chairman, I have been around business for a good share of my life and I think this has a good chance of working. The first approach was an invitation for problems. To sum up, for welfare reform to work, there must be jobs for job seekers, and this is a good way to help the process along. It is a good investment, and in the long run it is going to save the government money.

Thank you very much.

[The prepared statement follows:]

STATEMENT OF THE HONORABLE AMO HOUGHTON

BEFORE THE SUBCOMMITTEE ON OVERSIGHT

COMMITTEE ON WAYS AND MEANS

MAY 9, 1995

Madame Chairman, members of the Subcommittee, I am pleased to have the opportunity to appear before you to discuss a new Targeted Jobs Tax Credit program. The Targeted Jobs Tax Credit (TJTC) was enacted in 1978 to improve the private sector employment prospects of disadvantaged individuals. The credit expired on December 31, 1994 after being extended by Congress on nine occasions, most recently in the Omnibus Budget Reconciliation Act of 1993. Prior to January 1, 1995, certain employers could claim a credit based on qualifying wages paid to individuals from nine targeted employee groups. The targeted groups consisted of individuals who generally were recipients of payments under means-tested transfer programs, were economically disadvantaged, or were disabled. The credit was equal to 40 percent of up to $6,000 of first-year wages paid to a certified member of a targeted group. Thus, the maximum credit was $2,400 per individual. With respect to economically disadvantaged summer youth (aged 16 and 17, working between May 1 and September 15), the credit was equal to 40 percent of up to $3,000 of wages, for a maximum credit of $1,200.

I have developed a new program after consulting with those in the private sector who have been involved in placing and hiring individuals eligible for the program. In addition, I have reviewed the comments of those who have criticized the existing program and believe my new proposal, which is before you, addresses their concerns.

The new JOBS program targets two groups: a.) those who are receiving public assistance or b.) Youths at high risk in danger of becoming dependent on it. At the same time, the new TJTC program calls for streamlining its administration through use of objective eligibility criteria wherever possible. Precertification should eliminate any identified abuses while at the same time keeping the program user friendly.

I support the new Targeted Jobs Tax Credit program because I believe it will help to achieve a critical goal of this Congress -- providing private sector employers with the appropriate incentives to hire and train those individuals in our society who are economically disadvantaged and who are receiving or at risk of longtime dependence on public assistance programs. If we continue to have as our goal moving people away from dependence, then it is incumbent upon us to provide the private sector with the incentives they will need to hire the economically disadvantaged.

Ultimately, if we are to be a productive society, we must look to the private sector, not the public sector to provide permanent employment for our citizenry. That is why I believe that there is no better time than right now to forge a new public / private sector partnership to move people from dependency to self-sufficiency.

What convinced me to develop an improved Targeted Jobs Tax Credit program were the statistics from my own State and district. Since 1978 over 374,000 people have been hired under TJTC at a savings to New York employers of $523 million. In 1994 alone, the savings to New York employers totaled $60 million. Over the nearly 16 years of the program the State Department of Labor estimates an economic multiplier effect on the economy of New York of $10 billion.

During 1994, hiring from the categories of Medicaid, public assistance, and SSI recipients represented a federal net savings of $7.9 million. This translated into reduced spending on these programs for my State's taxpayers of $34 million.

During 1994, in my home district, there were 317 TJTC hires within the categories of welfare recipients, disabled, and ex-offenders. Taxpayers in these counties saved $1.65 million in public assistance and home relief. This amounted to a cost to the Treasury of $443,000. When reduced federal welfare, Medicaid, and SSI payments for 1994 were considered, the cost to the federal taxpayer of the TJTC program was reduced from $443,000 to $37,000.

Based upon the analysis supplied to us by New York State, in addition to what I have heard from employers across the nation, I am convinced that a TJTC program makes economic sense. We need to reinstate it as quickly as possible.

There have been valid criticisms of the program. The previous TJTC was successful, but the criticisms raised by the Department of Labor must be addressed. As a result, I have examined the concerns that have been raised. The private sector, the companies actually hiring the economically disadvantaged, incur extra costs when they choose to hire and train the structurally unemployed. That is exactly what the tax credit is designed to offset. A workable credit needs to provide a benefit to the public sector also.

As you have heard, the New York experience indicates that credit's costs are significantly offset by dramatic reductions in public assistance payments. Yet at the Federal level, because of the way we score tax incentives, we fail to take such spending savings into account. We also fail to account for the long term benefits to our society of moving people into the work force and away from dependency.

Madame Chairman, I have taken the liberty of distributing to the members of the Subcommittee a discussion draft of the new TJTC program which I intend to introduce shortly. At this point, I await a revenue estimate by the Joint Committee on Taxation and have as my goal to introduce a bill with approximately the same revenue impact as the previous TJTC program.

The first, and I believe the most significant change would be to require employers to pre-screen potential hires for TJTC eligibility prior to offering them a job. This would eliminate the so-called employer windfall issue. Probable TJTC eligibility would be known to the employer before a job was offered.

The next most significant change would encourage the transition from dependence to independence. Thus, the new TJTC program would extend the current welfare, SSI, and general assistance eligibility to include those receiving food stamps, WIC (Women, Infant, and Child), Medicaid and public housing benefits.

Higher wage and retention incentives have been incorporated. The credit would be in two tiers. Instead of the current 40% of the first $6,000 in wages earned, the new credit would be 35% of the first $5,000 earned in the first six months of employment. During the second six months of employment, the credit would be 45% of up to $5,000 in wages earned. The credit is backloaded to reward employers who are successful in keeping their TJTC workers on the job for a full year.

The high-risk youth category has been expanded to recapture 23 and 24 year olds who were dropped from the original program. Statistics indicate that those with little job history and few job skills by the time they reach ages 23 or 24 are at the greatest risk of joining the permanently unemployed and entering a life of economic dependence, or even worse, crime and drug addiction.

The veterans category has been changed to cover all veterans, not just those from the Vietnam era, who have been on public assistance during the previous 18 months. Ex-offenders, and summer youth would also be eligible for a credit. The remaining categories of eligibility from the old program have been dropped.

Most of the previous administrative difficulties and delays will be eliminated through the use of objective eligibility criteria, and the use of uniform, nationwide application forms.

I hope the Subcommittee will agree that we need to provide the private sector with the incentives it needs to seek out and hire the traditionally "hard to employ". I believe the improved TJTC program can go a long way toward fulfilling that policy goal. I look forward to receiving the Subcommittee's input and working with you on this important issue.

Chairman JOHNSON. Thank you, Mr. Houghton.
Mr. Collins.

STATEMENT OF HON. MAC COLLINS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF GEORGIA

Mr. COLLINS. Thank you, Madam Chairman.

I thought it was just me down here getting old and could not hear well, but I am glad to see that Amo says also he has a problem with the acoustics in this room from this perspective.

We appreciate the opportunity to discuss with you and other Members of the Committee today H.R. 752, which is to repeal a tax that has actually not been levied yet, but will come up later this year dealing with aviation fuel.

As a bit of information, Madam Chairman, we have at this point over 60 cosponsors of this piece of legislation, that is Ms. Dunn and I who actually introduced the bill, 19 Members of the Ways and Means Committee I am pleased to announce are cosponsors. For those of you who are not, we hope by the end of the day that your names can be added to the list.

Madam Chairman, it is a well known fact that the airline industry has suffered tremendously in the last few years and their financial situation is not good overall. A strong airline industry is very important to this Nation. It provides not only a number of jobs in the service area that they render, but also in many other areas that are affiliated with the airline industry as far as manufacturing or even offsite jobs around the many hubs that we have in this country.

The airline industry itself—and I have talked to a number of the chief executive officer's—actually supported the idea of deregulation several years ago, and I commend them for the way they have actually adjusted to deregulation. It has caused some tremendous difficulties for them, but they have adjusted well. Shortly after the deregulation, they had a serious downturn in the economy. We as the Federal Government, unfortunately, have compounded the problems of our Nation's airline industry with heavy-handed fees and taxes, placing the industry again in extreme financial jeopardy. This is what we hope to address and help them with in this particular provision.

I want to make a few major points and I would like to respond to any questions from the Subcommittee. First of all, beginning in October of this year, the airline industry will be required to pay a new 4.3-cents-per-gallon tax on jet fuel under the terms of the Omnibus Budget Reconciliation Act of 1993.

The tax is projected to cost the airlines more than $527 million annually, and that is already on top of $6.5 billion in annual fees and taxes industry has already collected, which again is on top of any local, State, and Federal taxes which businesses already pay.

The point I hope everyone will keep in mind is that the industry is not trying to escape paying its fair share of the country's tax burden, because the industry is already paying more than their fair share. As the government continues to add more and more taxes, the airline industry is struggling through its worst financial crisis in history.

Just consider this situation since 1990; the industry has lost a staggering $13 billion, and that is without a fuel tax. The airline industry has laid off almost 120,000 people. The increase in tax equates to the annual cost of compensation for an average of 10,000 employees. The U.S. airlines have either canceled or deferred orders and options on more than 1,000 aircraft, and 125,000 high-paying aircraft manufacturing jobs have been eliminated.

With the exception of Southwest Airlines, every airline has a "junk" credit rating with the capital markets. Even airlines, traditionally considered strong, pay a fortune now to borrow money. In the third quarter of last year, the Standard & Poor's stock index listed the airlines last in the industry groups. The 500 companies in the S&P 500 stock index fall into 88 industry groups. Airlines are listed number 88, dead last.

Notwithstanding this condition, in the past 4 years, virtually every Federal tax or fee imposed on the industry has been increased. In addition, two new fees were added, passenger facility charges and the agriculture inspection fee.

I think many Members of Congress hold the view that these fees do not affect the industry, because they can pass it on to the passenger. The reality is that the pressures of competition is so strong that the airlines have to absorb these fees. Thus, a percentage increase in the mandated fee becomes the same percentage removed from the profitability of the airline. That, I believe is the underlying reason for the $13 billion loss over the past 4 years.

The fuel tax was enacted to help lower the Federal budget deficit. However, some fees paid by the airline industry already go toward supporting government functions and deficit reduction.

For example, the Aviation Trust Fund covers 75 percent of the costs of operations of the Federal Aviation Administration. The customs user fee was increased from $5 to $6.50 to pay for NAFTA, the North American Free Trade Agreement, although aviation rights are not part of the NAFTA Treaty. The passenger ticket tax was increased from 8 to 10 percent in 1990, with 2 percent diverted from the Aviation Trust Fund to the general fund for 2 years to help pay down the deficit.

I also want to mention, Madam Chairman, that this legislation has extremely broad support from businesses throughout the country. I was privileged to a letter not too long back that listed a number of those supporters.

In closing, I want to emphasize that it is time to put a stop to this irresponsible action. The airlines are not cash cows. They are taking aggressive actions to restructure and return to sustained profitability. This is requiring tough choices and difficult sacrifices. Employees have made significant wage and benefit concessions to help provide financial stability for their airlines and their families, and it is beyond all reason to continue to have them pay so much more than their share.

Again, thank you for this opportunity. Ms. Dunn will follow me, and we will both be open to questions from the Committee. Thanks again.

Chairman JOHNSON. Thank you very much for your testimony.

Ms. Dunn.

STATEMENT OF HON. JENNIFER DUNN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF WASHINGTON

Ms. DUNN. Madam Chairman, Mr. Matsui and Members of the Committee, it is an honor and a pleasure for me to appear before this Subcommittee to testify on behalf of H.R. 752, a measure that will repeal the commercial jet fuel tax.

Madam Chairman, Mac Collins and I both appreciate the support expressed by this Subcommittee and the Full Committee in supporting our bill. As Mr. Collins said, 19 Full Committee Members support our bill, and 6 Members of this Subcommittee also are sponsors.

I am an original cosponsor of the legislation and a strong supporter of the airline industry. Yet, I cannot begin to express the level of support I feel for this bill. Given the prominence of the Boeing Co. in Washington State, certainly this is a parochial problem for me and for my good friend and colleagues on the Ways and Means Committee, Congressman McDermott. Both of us have many aviation employees who live in our respective districts.

Yet, this is a much larger problem with national implications. It affects millions of citizens through regional job losses and reduced commercial and passenger service.

Mr. Collins and I have compared our testimony, so as not to be too long or redundant. The facts that he presented are accurate and, as accurate as they are, astounding. I would like to offer a few facts of my own.

As Mr. Collins noted, since 1990, 125,000 aircraft manufacturing jobs have been lost. In that period, Madam Chairman, 50,000 of these jobs have come from the Boeing Co., from my part of the country and the largest aviation manufacturer. In February, Boeing announced another 7,000 layoffs, and the Nation's other leading aircraft manufacturer, McDonnell Douglas, announced that it might halt production of its largest airliner, the MD–11. Both McDonnell Douglas and Boeing have had to take such actions because of one simple reason. The domestic airlines cannot afford to purchase many new airplanes.

Madam Chairman, the airlines have lost almost $13 billion—service is being cut, carriers are going under, and others are threatened. Our industrial aviation manufacturing base is under severe stress, and yet the U.S. Government will soon impose an additional tax of over $520 million per year on the industry.

Mr. Collins mentioned that the aviation industry already pays a number of taxes. I would like to list some of those for you, and these are 1994 numbers. The airline industry pays a passenger ticket tax of $4.742 billion a year, a cargo waybill tax of $261 million a year, an international departure tax of $235 million a year, an INS, Immigration and Naturalization Service, user fee of $264 million a year, a customs user fee of $283 million a year, an agriculture inspection user fee of $81 million a year, and in 1994 a passenger facility charge of $782 million a year. They are not trying to escape taxes, Mr. Chairman.

In February, I met with Herb Kelleher, who is the chief executive officer of Southwest Airlines, a company that has been doing reasonably well. His point was both succinct and clear: This new tax which will be imposed beginning October 1 will severely hurt his

currently profitable airline, reduce the ability of Southwest and other carriers to purchase planes from Boeing and McDonnell Douglas, and will severely threaten the viability of other carriers.

Madam Chairman, I hope this Committee will heed the advice of Mr. Kelleher. I pledge to work with you to repeal this dangerous and ill-advised tax.

In fact, Mr. Collins and I have also introduced a bill that will serve as a partial offset for this burdensome airline jet fuel tax, H.R. 1024, the privatization of the Government Printing Office, and that has been given a preliminary scoring by CBO of right around $1.5 billion. Mr. Collins and I have testified in front of the Budget Committee and the Transportation and Infrastructure Committee regarding our plan to remove the jet fuel tax in a fiscally responsible manner.

Madam Chairman, I thank you for this opportunity to appear before the Committee.

[The prepared statement follows:]

Testimony

Congresswoman Jennifer Dunn

Madam Chairman, Mr. Matsui, and Members of the Committee, it is an honor and a pleasure for me to appear before this subcommittee to testify on behalf of H.R. 752, a measure that will repeal the commercial jet fuel tax.

Madam Chairman, Mac Collins and I both appreciate the support expressed by this subcommittee and the full committee in supporting our bill. For the record, 19 Members of the Ways and Means Committee and 6 Members of this subcommittee are cosponsors.

I am an original cosponsor of this legislation and a strong supporter of the airline industry, yet, I cannot begin to express my level of support for this bill. Given the prominence of Boeing in Washington state, this is a parochial problem for myself and my good friend Congressman McDermott. We both have many aviation employees who live in our respective districts.

Yet, this is a much larger problem with national implications. It affects millions of citizens through regional job losses, and reduced commercial and passenger service.

Last night, Mr. Collins and I compared our testimony so as to not be too long or redundant. The facts that he presented are as accurate as they are astounding. But, let me add a few facts of my own.

As Mr. Collins noted, since 1990, 125,000 aircraft manufacturing jobs have been lost. But, Madam Chairman, in that period, 50,000 of those jobs have come from The Boeing Company -- from my part of the country and the largest aviation manufacturer. And in February, Boeing announced another 7,000 layoffs and the nation's other leading aircraft manufacturer, McDonnell Douglas, announced it might halt production of its largest airliner - the MD-11.

Both, McDonnell-Douglas and Boeing have had to take such actions because of one simple reason: the domestic airlines cannot afford to purchase many new planes.

Mr. Madam...the airlines have lost almost $13 billion...service is being cut...carriers are going under and others are threatened...our industrial aviation manufacturing base is under severe stress, and yet, the United States Government will soon impose an **additional** tax of over $520 million dollars per year on the industry.

Let me list the taxes **already being** paid by the airlines:

1994 NUMBERS (Estimated)

TAX OR FEE	AMOUNT	TOTAL REVENUE LOSS
Passenger ticket tax	10%	$4,742,000,000
Cargo waybill tax	6.25%	261,000,000
International departure tax	$6.00	235,000,000
INS user fee	$6.00	264,000,000
Customs user fee	$6.50	283,000,000
Agriculture inspection user fee	$1.45	81,000,000
Passenger facility charges	$3.00	782,000,000
TOTAL		**$6,648,000,000**

1993 NUMBERS

TAX OR FEE	AMOUNT	TOTAL REVENUE LOSS
Passenger ticket tax	10%	$4,472,000,000
Cargo waybill tax	6.25%	255,000,000
International departure tax	$6.00	223,000,000
INS user fee	$5.00	220,000,000
Customs user fee	$5.00	138,000,000
Agriculture inspection user fee	$1.45	74,000,000
Passenger facility charges	$3.00	486,000,000
TOTAL		**$5,868,000,000**

In Februry, I met with Herb Kelleher, CEO of Southwest, an airline that has been doing reasonably well.

His point was both succinct and clear. This new tax, which will be imposed beginning October 1st, will severely hurt his **currently** profitable airline, reduce the ability of Southwest and other carriers to purchase planes from Boeing and McDonnell Douglas, and severely threaten the viability of other carriers.

Madam Chairman, I hope this committee will heed the advice of Mr. Kelleher. I pledge to work with you to repeal this dangerous and ill-advised tax.

Chairman JOHNSON. Thank you very much.
I would like to recognize Hon. Mr. Roth.

STATEMENT OF HON. TOBY ROTH, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF WISCONSIN

Mr. ROTH. Thank you, Madam Chairman. I am delighted to join my colleague Mr. Collins, Mr. Houghton, and Ms. Dunn before the Committee this morning.

I am here to testify in support of the permanent exemption for our airlines, the 4.3-cents-per-gallon transportation fuel tax which would be going into effect October 1.

A question was asked here this morning by Mr. Houghton. He asked where are the jobs going to come from. I will tell you where the jobs are going to come from. The jobs are going to come from the area of travel and tourism. With the huge trade deficit we have this year, one area where we have a trade surplus is in the area of foreign tourists coming to the United States. We are getting in about $1.5 billion because of foreign tourists coming here and shopping and giving us that kind of a trade surplus. This is why tourism is so important.

As the Chairman of the Travel and Tourist Caucus, I can tell you that the restaurants, the small stores, small businesses, hotels and service industries in our State of Wisconsin, if we have a good tourism year, we have an additional 147,000 jobs, and that is even more true for Maryland, Michigan, California, Connecticut, Missouri, or Texas. This is true throughout our country, and that is why this has such a tremendous impact on us.

The unreasonable tax that would be imposed on one segment of the travel and tourist industry, the airlines, will cost good paying jobs, essential travel services, and quite possibly will deliver a crushing blow to many of the U.S. carriers struggling to get back on their feet.

As Chairman of the Travel and Tourist Caucus, Madam Chairman and Members of the Committee, I know firsthand how vital our Nation's airlines are to the health of the U.S. economy. Travel and tourism added $127 billion to the national coffers last year. People like you have a tremendous responsibility. I again want to emphasize, $127 billion came into our national coffers because of travel and tourism, and this is many times lost. Travel and tourism adds $127 billion to the national tax coffers, with several billion dollars coming directly from the airlines industry.

In addition to these Federal taxes and other State taxes, the airlines pay over $6 billion in passenger and excise taxes, the equivalent of a 46-cents-per-gallon fuel tax. The airline industry already pays their fair share, as has been so adequately pointed out in the testimony this morning, of the American tax burden. Even under today's Tax Code, the airlines have lost a staggering $12.8 billion in the last 4 years, and that is something I think we have to always keep in mind.

While in recent months the industry has shown small signs of recovering from the $12.8 billion loss, recovery has come only at the sacrifice of 120,000 U.S. airline employee jobs and 125,000 U.S. aircraft manufacturing jobs. Midwest Express, one of the companies that is in my congressional district, has estimated that if the fuel

tax had been in place in 1994, it would have cost the airlines $2 million. That amounts to 22 percent of their total operating revenue for last year alone.

Madam Chairman and Members of the Committee, I think that we have to make sure that the companies pay their fair share, but let us not drive these people out of business. If they do not have any business, we do not have jobs, we do not have jobs in our restaurants and our motels and all across the board. We do not have profits, no jobs, and also no taxes.

This bill acknowledges the sacrifices of airline industry employees who took pay cuts to keep their companies in business. It promotes economic growth and employment in one of our Nation's most dynamic and untapped industries of the travel and tourism industry. For that reason, Madam Chairman and Members of the Committee, I hope that you will agree with the panel here this morning and also with our testimony.

Thank you.

[The prepared statement follows:]

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INTERNATIONAL RELATIONS COMMITTEE
CHAIRMAN
INTERNATIONAL ECONOMIC
POLICY AND TRADE SUBCOMMITTEE

COMMITTEE ON BANKING AND FINANCIAL
SERVICES
FINANCIAL INSTITUTIONS AND
CONSUMER CREDIT SUBCOMMITTEE

United States
House of Representatives

Testimony
Representative Toby Roth
House Committee on Ways and Means
Subcommittee on Oversight

May 9, 1995

Mr. Chairman:

I testify today in support of a permanent exemption for the airlines from the 4.3 cents per gallon transportation fuel tax set to take effect on October 1, 1995.

This permanent exemption is one provision of H.R. 1083, "The Travel and Tourism Relief Act of 1995," which I introduced in the House of Representatives February 28, 1995.

The five provisions of the Travel and Tourism Relief Act are 1.) to permit travel agents independent contractor status, 2.) to restore the meal and entertainment tax deduction from 50 back to 80 percent, 3.) to make permanent the 4.3 percent airline fuel tax exception, 4.) to provide a tax credit for companies promoting the U.S. abroad, and 5.) to allow tax deduction for business meeting held on cruise ships.

All of these provisions are important, but today I want to speak on behalf of provision three, the necessity of of a permanent airline fuel tax exemption.

We all want to make sure that all businesses pay their fair share of taxes, whether it is a large corporation or the Mom and Pop corner store. But all too often, the travel and tourism industry is singled out as the tax collector's cash cow.

And this time, the unreasonable tax that has been imposed on one segment of the tourism industry -- the airlines -- will cost good-paying jobs, essential travel services, and quite possibly will deliver the crushing blow to many of the U.S. carriers struggling to get back on their feet.

With this additional tax, the airline industry will suffer unduly at the hands of the big spenders -- big spenders who intend to spend more than America has and do so at the cost of American workers and American businesses.

As Chairman of the Congressional Travel and Tourism Caucus, I know firsthand how vital our nation's airlines are to the health of the U.S. economy. Travel and tourism adds $127 billion to the national tax coffers, with several billion coming directly from the airline industry.

In addition to these Federal taxes and other state taxes, the airlines pay over $6 billion in passenger and excise taxes -- the equivalent of a 46 cents per gallon fuel tax.

The airlines already pay their fair share of the American tax burden. Even under today's tax codes, the airlines have lost a staggering $12.8 billion during the last four years. This industry is already on less than stable ground.

Even as the airlines struggled just to survive, the Clinton Administration's tax plan of 1993 imposed the 4.3 cents per gallon fuel tax, now scheduled to take effect October 1, 1995.

Mr. Chairman, this tax will cost airlines an additional $527 million a year -- a devastating blow. The cost to the U.S. economy will be even greater.

A healthy U.S. airline industry is critical to the vitality of our nation's economy. The Congressionally-mandated National Airline Commission stated in its 1993 report that to return the industry to profitability, Congress must act to "relieve the airline industry of its unfair tax and user fee burden."

While in recent months, the industry has shown small signs of recovering from its $12.8 billion loss, recovery has come only at the sacrifice of 120,000 U.S. airline employee jobs and 125,000 U.S. aircraft manufacturing jobs.

Employees whose jobs were not eliminated accepted substantial wage and benefit decreases, with total airline industry concessions in excess of one billion dollars annually.

Mr. Chairman, it would be more than an exercise in poor judgement to inflict an additional $527 million tax on an industry and its employees who have struggling so hard to regain financial footing.

This tax is bad public policy.

It will affect us all by upsetting essential aviation services, raising unemployment, increasing ticket prices, and quite possibly by forcing some of our nation's airlines into bankruptcy.

Midwest Express, one of the airlines that services my own district in Northeast Wisconsin, estimated that if this tax had been in place in 1994 it would have cost their airlines $2 million.

That amounts to 22 percent of their total operating revenues for last year alone!

Mr. Chairman, my bill H.R. 1083 makes permanent the exemption of commercial airlines from this job-killing transportation tax.

The National Airline Commission officially stated that the airline industry can not financially absorb another tax hit of this magnitude.

Ladies and Gentlemen, we must make sure companies pay their way, but let's not drive them into the ground.

The Travel and Tourism Relief Act enables the airlines -- a critical segment of the tourism industry -- the opportunity to sustain their economic recovery.

This bill acknowledges the sacrifices of the airline industry employees who took pay cuts to keep their companies in business.

And it promotes economic growth and employment in one of our nation's most dynamic and untapped industries -- travel and tourism.

I urge my colleagues to support the Travel and Tourism Relief Act and to support the jobs of thousands of travel agents, restaurant owners, small businessmen and women and particularly airline employees who are directly at risk with this airline fuel tax.

Chairman JOHNSON. I thank the panel for your excellent comments.

There are a couple of other Members who, for various reasons such as plane schedules, will not be here until later and they will be allowed to testify at that time.

First of all, I do think a healthy airline industry is important to a strong economy. I appreciate the wealth of data that you have presented to us and the fact that you did not allow your testimony to overlap too much.

We will be looking in the course of this hearing at the tax burden on airlines versus other modes of transportation, as well as looking at the broader picture of the role of the airline industry in our economy.

It is also true, however, that when we pass a tax and exempt one industry because of its health, we do that in the context of not looking at the health of carriers in other industries, as well. We do want to look at the equity issues for other modes of transportation in the course of this hearing. You have provided us with excellent information and a fine place to start, and I thank you for that.

Amo, I look forward to the details of your reform proposal. I hope that when the Department of Labor testifies today, that they will have a reform proposal, because they have long said that the current program is not workable and does not accomplish our goals effectively. I share with you the belief that the concept is an important one and am disappointed that to this point the Department of Labor has not come forward with their idea of what reform would represent.

I am pleased that you and Charlie are taking on that task. I would urge you, however, to move forward rapidly, because, as you and I know, decisions about how much we are going to have to raise and what we are going to have to do are going to fall rapidly upon us.

Do other Members of the Committee have questions? Mr. Matsui.

Mr. MATSUI. Thank you, Madam Chairwoman.

I want to thank all four of the Members of the panel, and I also look forward to working with the three of you who talked about the aviation fuel tax.

I would like to touch on Mr. Houghton's targeted jobs tax credit issue. First of all, I want to commend you and Mr. Rangel for trying to reform this particular tax credit. Certainly, I think we learned last year that it is in need of major reform. Unless we do, I cannot see us actually extending it and making it permanent. I think your efforts will go a long way in making sure it does work.

Without getting to specifics, because you have not introduced the bill yet, you are going to raise the threshold from $6,000 to $10,000. Would you perhaps explain why that is? Perhaps it is a little premature yet. If it is, just tell me. If you have the answer to that, could you explain it? Perhaps you could also talk about the possible revenue implications, if in fact, it will be more or less. Again, I know it is early.

Mr. HOUGHTON. Mr. Matsui, there are a couple of reasons for the increase. First of all, inflation has taken its toll. Also, if you multiply 425 times 2,000-plus, you get—I mean it is way out of whack.

It is not a realistic number for the year 1995, so that is primarily why we had to include an increase.

As far as the revenue implications are concerned, I have no idea. I have tried to get some revenue answers. I have not been able to get them. The old program costs about $2 billion over 5 years, actually $1.9 billion, so let us say that averages how many dollars a year. That is one way of looking at it.

The other way of looking at it that has been very tempting to me to explore, is if you take somebody on welfare and you add up all the costs, you get the equivalent of about $12,000 a year. If you compare that to $4,000 a year as benefit for the corporation or net that out with a 35-percent tax rate to about $2,600, The proportions are way off. It does cost money for the government, but in terms of shifting that from the welfare program I think net to net it is a great savings.

Mr. MATSUI. I understand also you are going to shrink the number or the kinds of employees that will actually be able to use the credit, which probably will help reduce the revenues a little bit.

Mr. HOUGHTON. Right.

Mr. MATSUI. Obviously, the main issue is to make sure that when these people are hired under this program, that they become permanent employees, rather than 6 months hired and then later laid off and having the employer take advantage of basically a tax credit. I think that is an issue you are working on now.

Mr. HOUGHTON. Exactly. Imagine yourself running a small operation, and all of a sudden an ex-felon or somebody who has not had a very good record, has been on welfare for a long time, comes up and says I want to get a job. He has no skills. You have got to have a very big heart to be able to take that person on. Frankly a lot of people doing it have worked out. Just this extra nudge, with all the preconditions which we put into this new bill, I think it is really worth a chance.

Mr. MATSUI. Thank you.

Mr. HOUGHTON. Thank you.

Chairman JOHNSON. Do other Members have questions or comments?

Mr. Hancock.

Mr. HANCOCK. My good friend from New York, I would like to ask a question. One of the things I hear in the small business community is, they are very concerned, most businessmen would like to help get people off welfare. It is understood that it is good if they can do this as citizen involvement.

In many cases, though, I have had small businessmen say, look, I just cannot take the risk. I tried it once, and the next thing I knew the guy did not work out. I had the wage and hour people on me. Attorneys were in on it, and it cost me $25,000 in legal fees to get the government off my back, because I was willing to take a risk by hiring this disadvantaged individual.

I am sure that did not work out all the time, but is there some way or could you consider some way to try to control the risk and the liability on the small business community, if in fact they are willing to take on that risk?

Mr. HOUGHTON. I think the agency is going to have to do that. I think if the agency dishes up somebody who has broken into

stores and held up various people and has absolutely no remorse about this thing and is really a high-risk employee, then that is wrong. That will probably happen, but it should not. This is why the tightening up of these preconditions are concerned.

As you know, Mr. Hancock, business is money and you are willing to take a risk if the incentives are there. This is why the incentives are here in this program.

Mr. HANCOCK. A risk that you do not have to take, very few businessmen are going to take it.

Mr. HOUGHTON. If there is no financial incentive to offset the imagined risk in your mind, you are not going to take it, period.

Mr. HANCOCK. I am still saying, though, that if you would consider—I am just asking the question—if you would consider some way to include in your bill some type of relief, some type of protection for the businessman that is willing to take the risk, not because—I am sure there is an incentive to make this successful, but he may be doing it just out of the goodness of his heart. There are people who do things like that.

Thank you very much.

Mr. HOUGHTON. Could I just answer that? If you have got ideas that are not overly burdensome and do not put a tremendous liability on the part of the agency or the government that is doing this, I would love to see it, because I think there are some things that can be changed here. Frankly, maybe a cap should be considered, maybe a sunset provision, maybe things like that. Let me know and I will be willing, and I am sure Mr. Rangel also, to work this into our bill.

Mr. HANCOCK. Thank you very much.

Madam Chairman, I would like to take this opportunity to ask unanimous consent to submit a statement for the record by Sam Fox of Clayton, Missouri, supporting the permanent extension of section 170(e)(5), which prior to expiration permitted a tax deduction for donations of appreciated marketable securities to private foundations. I ask that this statement be included at the appropriate place in the hearing record.

Chairman JOHNSON. Without objection.

Mr. HANCOCK. Thank you, Madam Chairman.

[The prepared statement follows:]

STATEMENT BY SAM FOX OF CLAYTON, MISSOURI WITH RESPECT TO EXTENSION OF IRC SECTION 170(e)(5) REGARDING CONTRIBUTIONS TO PRIVATE FOUNDATIONS

This statement is submitted by and on behalf of Sam Fox of Clayton, Missouri in support of the permanent extension of Section 170(e)(5) of the Internal Revenue Code which, until December 31, 1994, permitted tax deduction (within certain prescribed limits) of donations of appreciated marketable securities to private foundations.

My name is Sam Fox. I reside in Clayton, Missouri. I am the Chairman and Chief Executive Officer of Harbour Group, which, together with its affiliated organizations, manages and owns substantial interests in a number of industrial groups having manufacturing facilities throughout the United States and Europe.

I, together with my wife, are founders of the Fox Family Foundation, a private charitable foundation, qualified as such under Section 501(c)(3) of the Internal Revenue Code.

The Fox Family Foundation is not merely a passive conduit of funds to large public charities. A significant part of its activities involves the active selection of grant recipients, usually small agencies engaged in important social welfare projects, but who do not have the wherewithal to support broad fund solicitations. Each year the Foundation provides grants to more than 150 organizations. Grant recipients include such organizations as the Crusade Against Crime/Child Assistance Program to provide funding to employ a part-time social worker, the St. Louis Community Aging Corporation to provide support services for senior project tenants, the Food Outreach program to help provide food to indigent persons suffering from AIDS, Hamilton Heights Housing for its job training program and the St. Louis Child Abuse Network to employ a family therapist. The Foundation also provides seed money for start up charities such as the Alliance for Mentally Ill/Self-Help Center to cover salaries for a fund raiser and program director.

My wife and I and our five children serve as Trustees of the Foundation. The Foundation has two full-time employees. Its finances are audited by Price Waterhouse and its legal requirements are provided by the law firm of Dickstein, Shapiro & Morin L.L.P. of Washington, D.C.

In the past, funding for Foundation activities has been generally provided by large annual cash contributions by me and my wife. However, in addition to annual cash contributions in support of current activities, we are now seeking to establish a substantial endowment so that the Foundation can maintain continuity in its charitable activities for decades to come. In 1994 my wife and I contributed over $6 million of appreciated, marketable securities to the Foundation. Such securities consisted of common stock of four public companies that had been established by Harbour Group in which my wife and I have very substantial positions.

The expiration of Section 170(e)(5) of the Internal Revenue Code has produced the anomaly that contributions of appreciated stock to public charities are deductible at their fair market value while such contributions to private charitable foundations are not. This works to the disadvantage of small, grass-roots charitable organizations, such as those supported by the Fox Family Foundation, which do not have the staff or infrastructure to manage endowments or even to deal with contributions of securities. I believe there is no valid reason for this discriminatory differentiation between public charities and private foundations. Certainly, the panoply of law, regulations and enforcement mechanisms governing private foundations should preclude any concern over abuse or misuse. Moreover, for the reasons stated, private foundations can operate with an intimate knowledge of community needs that would normally be outside the ken of large public charities.

If Section 170(e)(5) is extended for 1995 and years subsequent, it would be our intention to continue to make similar substantial stock contributions to the Foundation. On the other

hand, if Section 170(e)(5) were not to be extended, our cost basis in such shares is so low that it would make little sense for us to contribute such shares to the Foundation except perhaps by testamentary disposition after the last of us has died. At the very least, this would most probably produce a very long deferral of such contributions and a substantial diminishment of the Foundation's capacity to perform charitable activities which would otherwise be funded at a rate of not less than five percent of the value of the Foundation's retained assets.

I am aware that the Joint Committee on Taxation has earlier estimated that the extension of Section 170(e)(5) would produce a five year revenue loss of some $280 million. Even if that were the case, I believe that the benefits to be derived from the additional charitable activities that extension of Section 170(e)(5) would generate would more than reciprocate for such loss. But if the behavior of other taxpayers in my situation is similar to my own, I question the assumptions on which that presumed revenue loss has been based. For revenue losses would only be incurred if taxpayers owning securities with substantial unrealized appreciated gains would choose to sell those securities and pay capital gains thereon in order to contribute the net cash proceeds to private foundation. I believe this to be highly unlikely particularly in situations that may constitute the bulk of such potential contributions where the prospective donor's holdings in a public company represent a substantial, perhaps controlling, interest in the public company.

Both federal and state budgetary considerations will necessarily diminish, if not preclude, government funding for activities such as those supported by the Fox Family Foundation. Moreover, it is my strongly held belief that funding of such activities is more effectively and less expensively performed by the private sector. Accordingly, I believe that an essential element of government downsizing would be to encourage private charitable giving in every possible way. Certainly, extension of Section

Chairman JOHNSON. Mr. Johnson.

Mr. JOHNSON of Texas. Thank you, Madam Chairman.

Mr. Houghton, I understand that you have got a separate category in your program for high-risk youths. I think there is a lot that would not fall under the means-tested program that needs our attention, and I wonder if you could discuss with me the separate category of high-risk youths as it appears in your plan.

Mr. HOUGHTON. The different categories of people who are eligible?

Mr. JOHNSON of Texas. Yes, high risk.

Mr. HOUGHTON. There are basically two. There is the group between 18 and 12, it used to be lower than that, who were either on public assistance or have a very good chance of getting on public assistance. There is this high-risk youth category from 16 to 21 years of age. About 75 percent come from the high-risk youth category. Those are the two basic categories.

Mr. JOHNSON of Texas. Those high-risk guys are those who have been without working role models, perhaps they are unskilled and oftentimes youth that turn to drugs and violence. I guess the program that you propose is supposed to provide them with some training and role models in the workplace which theoretically would—you know, they would otherwise be at risk of no economic recovery.

Mr. HOUGHTON. That is right. As you know, when we discussed the welfare bill, there is really no training until you have a job. If the incentive is there, the job is there, the AFDC Program comes in and really helps these people. There are so many of these training programs, they are going to try to boil them down from about 133 down to 1, so it is going to be expensive, but that is where that kicks in.

The end result you hope is to make a worthwhile solid individual out of somebody who is just on the brink all the time.

Mr. JOHNSON of Texas. Thank you, Mr. Houghton.

Mr. HOUGHTON. Thank you.

Mr. JOHNSON of Texas. Thank you, Madam Chairman.

Chairman JOHNSON. Thank you very much for your input today.

I would just add to my opening statement while Members are here this proviso. While I did recognize that we may be forced to consider temporary extensions, I think the whole concept of a balanced budget proposal, of the Congress taking on the responsibility of reaching some kind of balance between revenues and expenditures in 7, 8, or even 10 years means that we have an obligation right now to say this is the tax policy that we think will support services and a vital economy in that period and to pay for those things.

Temporary extensions do not do that. I personally feel a certain obligation to prefer permanence over temporary, because I think it is a more honest reflection of our commitment to setting out a spending path that reaches balance by the year 2002, but also encompasses both a spending policy and a tax policy that we believe will support a strong economy.

We will be putting a heavy emphasis on permanency and we will be looking at the alternatives to accomplishing the goals of the tax

provisions that people support. I invite your continued work with us as we go through this process.

Thank you for your excellent testimony this morning.

Mr. COLLINS. Thank you, Madam Chairman. I would like to emphasize, too, that we feel very strongly about the fact that we must work toward a balanced budget by the year that we have promised the public we would do so, and that is the year 2002. That is the reason it is done. I have identified some 40 billion dollars' worth of possible rescissions or changes in Tax Code offsets and spending that would help us pay for the assistance that we are trying to grant to the airline industry. We feel like a repeal of this upcoming tax will probably be much more beneficial in the long run. With the repeal and implementation of it from the standpoint of the operation of the airlines, their profits and the employees and the wages they earn and the taxes that are deducted from their wages, and also those who are affiliated with the airline industry through the airports and manufacturing or catering or whatever the other offset business or outside business may be.

We welcome the opportunity to offer offsets, and we welcome the opportunity to work toward a balanced budget. It will be very prosperous to this Nation the day that we reach zero deficit.

Thank you.

Chairman JOHNSON. Thank you.

I thank the panel and call the next panel. The next panel is the Deputy Assistant Secretary for Tax Policy of the Department of the Treasury, Cynthia Beerbower; also Hon. Doug Ross, Assistant Secretary for Employment and Training of the Labor Department; and Patrick Murphy, Acting Assistant Secretary for Aviation and International Affairs of the U.S. Department of Transportation.

Normally, as Committee Members know, I think it is only fair to indulge the administration witnesses, because I think your long experience is terribly important to us. However, because we have so many panels, I will have to also ask you to be as targeted in your remarks as you can be. I assure you that we will be willing to work with you throughout this process, but I would appreciate it if you focus your remarks as much as you can, and if the Committee Members will also try to focus their questions.

We will first hear from Ms. Beerbower, of the Treasury Department.

STATEMENT OF CYNTHIA G. BEERBOWER, DEPUTY ASSISTANT SECRETARY FOR TAX POLICY, U.S. DEPARTMENT OF THE TREASURY; ACCOMPANIED BY ELIZABETH WAGNER, STAFF ASSISTANT

Ms. BEERBOWER. Thank you, Madam Chair and distinguished Members of the Subcommittee.

I am pleased to present the views of the administration on the extension of the expiring tax provisions that are the subject of your hearings today, as well as tomorrow, and we thank the Subcommittee for allowing us to consolidate our comments for both days into one testimony.

The administration has supported and continues to support the revenue neutral extension of many of these provisions, and we look forward to working with this Congress in order to meet that goal.

I was pleased to hear your comments, Mrs. Johnson, just a few moments ago about the importance of permanent extension. As a matter of tax policy and consistent with our position in 1993, the administration believes that any extension of the provisions generally should be made permanent, particularly the research tax credit and the orphan drug tax credit, where temporary extensions create great uncertainty and make it very difficult for taxpayers to engage in long-term research decisions.

Temporary extensions create a host of complexities and administrative burdens for taxpayers, particularly when they are allowed to expire, as is the case with some of these provisions today, and then they are reinstated retroactively. Nevertheless, the administration is mindful of budgetary constraint. In considering the permanent extension of all of these incentives, we are happy to work with Congress on a bipartisan basis to develop financing options to pay for them.

The first provision I would like to address is the exclusion for employer-provided educational assistance. The administration supports the extension of the exclusion for employer-provided educational assistance. The exclusion, we believe, encourages employers to provide educational assistance, and it thereby increases our Nation's work force productivity.

In addition, the absence of the exclusion would impose significant administrative burdens on employers, workers and the IRS, Internal Revenue Service, who would need to distinguish between job related expenses, which are excludable from gross income under current law when paid by the employer and other employer-provided educational expenses which are not excludable and, therefore, among other reporting requirements, are subject to wage withholding.

Education and training of our work force is a high priority for this administration. In addition to the employer incentives set forth in this provision, the administration in the Middle-Class Bill of Rights has proposed a deduction for middle-income families for postsecondary education and training expenses.

Second, is the research tax credit. The administration consistently has supported the research tax credit and has recommended its permanent extension in 1993 for the 1994 budget. Unfortunately, that did not occur in Congress and it was only temporarily extended.

Again, in the administration's 1996 budget, we continue to support the permanent extension of the research tax credit. We recognize the importance of technology to our national ability to compete in what is now a very global marketplace. The research tax credit is a vital tool in developing, supporting and fostering American technology.

Third, the administration supports the permanent extension of the orphan drug tax credit. This credit has been helpful in making new drugs available for those suffering from rare diseases. The development of these drugs might not occur without the credit, since the low rate of return on sales of specialized drugs generally cannot justify the extensive research by biotechnology and pharmaceutical companies to develop them.

Fourth, the administration supports reinstating the full fair-market value deduction for gifts of qualified appreciated stock to private foundations. Private foundations perform an important role in funding the charitable sector. As the government reinvents, restructures and reduces in size, the charitable sector will be expected to take on the financial burden of an increasing number of public projects.

Thus, charitable giving needs to be encouraged. We believe that allowing the full fair-market value deduction for gifts of qualified appreciated stock will encourage the formation and funding of private foundations and will enable the charitable sector to better fund its increasing responsibilities.

Fifth, as stated in the President's 1996 budget, the administration supports the revenue neutral extension of section 864(f). In 1992, the Treasury undertook to study the allocation methodology for allocating research and experimentation costs between foreign source and domestic source income.

I am happy to say this morning that this study is nearly completed. In fact, we were hoping to be able to release the regulations this morning. We will shortly announce these regulations. One thing I can say about them is they are likely to be more favorable to taxpayers than the 1977 regulations.

Sixth, the administration opposes any general extension of the tax credit for producing fuel from nonconventional sources. When Congress enacted this credit, an objective was to support the development of new alternative technologies to recover oil and gas. The credit was intended to apply for a limited period of time only, after which Congress expected that no special incentive would be needed for the affected industries, since they would have matured and become competitive without government assistance over the life of the credit.

The 1992 extension for biomass and coal facilities was intended to be a transition rule for taxpayers with facilities that were soon to be placed in service. This transition period is now almost over, and we believe that a further extension is not warranted.

The administration also opposes any delay in the effective date of the 4.3-cents-per-gallon excise tax on fuel used in commercial aviation. When Congress increased the excise tax on fuels used in transportation, the intention was that all modes of transportation would be equally subject to this excise tax. The effective date of the tax on commercial aviation was delayed for 2 years because of the concerns that the commercial airlines industry generally was experiencing industry-wide losses.

Today's economic picture is different. As the economy has recovered from the recession, air traffic has increased and most airlines have experienced improvements in their financial condition. Thus, the industry is now in a better position to accommodate an excise tax of 4.3-cents-per-gallon on commercial aviation fuel. This tax is well within the range of the jet fuel prices over the last couple of years, and that type of fluctuation should be easily accommodated by the industry and has in fact been accommodated through the price fluctuations.

The employment of economically disadvantaged and disabled workers is undoubtedly one of the administration's most pressing

concerns. As Treasury testified last fall, however, there are problems with the targeted jobs tax credit that undermine its effectiveness. Because we are very concerned about the efficient use of government revenues, we believe that the problems undermining the credit's effectiveness must be addressed before pursuing an extension of this credit.

The Labor Department will discuss this further, but in August 1994 the findings by the Labor Department's Office of Inspector General were critical of the credit's effectiveness. My written testimony highlights a couple of the credit's problems and it offers general options for addressing these concerns. The Treasury Department looks forward to working with Congress on a bipartisan basis to address these problems that currently undermine the credit's effectiveness.

This concludes my prepared remarks, but I will remain until the other panelists have finished for questions.

Thank you.

[The prepared statement and attachment follow:]

STATEMENT OF
CYNTHIA G. BEERBOWER
DEPUTY ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

Madam Chair and distinguished Members of the Subcommittee:

I am pleased to present the views of the Treasury Department today on the extension of various expired or expiring tax provisions set forth in the Subcommittee's Notice of Hearing dated April 19, 1995.

As discussed in more detail below, the Administration has previously supported and continues to support the revenue-neutral extension of many of these expired or expiring tax provisions, and looks forward to working with this Subcommittee to achieve that goal. These provisions include the exclusion for employer-provided educational assistance, the research tax credit, the tax credit for orphan drug clinical testing expenses, the tax deduction for contributions of qualified appreciated stock to private foundations, and the rules regarding allocation of research expenditures. The Administration would also support the extension of the targeted jobs tax credit if the problems underlying the credit's effectiveness were addressed.

As a matter of tax policy, the Administration believes that any extensions of tax incentives generally should be made on a permanent basis. Temporary extensions undercut the desired incentive by creating uncertainty and making it difficult for taxpayers to make long-term business plans. Temporary extensions also contribute to complexity for taxpayers and may create administrative problems when the provisions are allowed to expire and are then reinstated retroactively. Nevertheless, the Administration is mindful of budgetary constraints in considering permanent extensions of these incentives. The Administration is happy to work with the Congress on a bipartisan basis in developing acceptable options for financing these extensions. (Attachment A shows the receipts effect of permanent extension of the expiring provisions.)

The Administration opposes extending the delayed effective date of the 4.3 cents per gallon tax on commercial aviation fuel enacted as part of the Omnibus Budget Reconciliation Act of 1993

(OBRA 1993). The Administration also opposes extension of the production credit for nonconventional fuels.

In addition to the various expiring provisions that are the subject of this hearing today, several other provisions of the tax code either have already expired or are scheduled to expire soon. As indicated in the Administration's Fiscal Year 1996 budget, the Administration supports extension of these provisions, which are described below:

-- Oil spill liability tax. Under prior law, a 5 cents per-barrel tax was levied on each barrel of domestic and imported crude oil entering a U.S. port. This tax, which was deposited in the Oil Spill Liability Trust Fund, was to expire on the earlier of December 31, 1994, or the date on which the unobligated balance in the fund reached $1 billion. This tax expired on December 31, 1994.

-- Generalized system of preferences (GSP). Under GSP, duty-free access is provided to over 4,000 items from about 142 eligible developing countries that meet certain worker rights and other criteria. This program, which was extended for 10 months under the Uruguay Round Agreements Act of 1994, is scheduled to expire after July 31, 1995.

-- Environmental tax on corporate taxable income. A tax equal to 0.12 percent of alternative taxable income in excess of $2 million is levied on all corporations and deposited in the Hazardous Substance Superfund Trust Fund. This tax expires on December 31, 1995. In addition, the Administration also supports extension of the excise taxes deposited in the Superfund, which are scheduled to expire December 31, 1995. These environmental excise taxes are the crude oil tax (9.7 cents per barrel for domestic crude oil and imported petroleum products), the tax on feedstock chemicals, and the tax on certain imported substances.

The Administration's detailed views regarding the expiring provisions that are the subject of today's hearings follow.

1. Exclusion for Employer-Provided Educational Assistance

Background

The exclusion for employer-provided educational assistance was first enacted on a temporary basis as part of the Revenue Act of 1978. It has been extended seven times. In its Fiscal Year 1994 budget, the Administration proposed permanently extending the exclusion for employer-provided educational assistance. OBRA 1993, however, provided only a temporary extension. The exclusion expired for taxable years beginning after December 31, 1994.

Current Law

Prior to expiration, section 127 provided that amounts paid by an employer with respect to an employee under an educational assistance program were excluded from the employee's gross income and wages for employment tax purposes to the extent that the value of the assistance did not exceed $5,250 per year, regardless of whether the expense would otherwise be deductible. Such programs were subject to nondiscrimination rules to ensure that the assistance was not provided primarily to higher-paid employees.

Education expenses incurred directly are deductible only if the education is related to the person's employment, and then only as a miscellaneous itemized deduction subject to the two percent of adjusted gross income floor. A deduction for education expenses is allowed only if the education maintains or improves a skill required in the individual's employment or other trade or business, or is required by the individual's employer, or by law or regulation for the individual to retain his or her current job.

Employer reimbursement of such expenses, however, may be excluded from income as a working-condition fringe benefit under section 132(d), and, unlike education expenses paid for by the employee, is not subject to the two-percent floor, nor is the deduction subject to a ceiling. The educational expense, however, must be job-related.

In the absence of section 127, the value of employer-provided educational assistance is included in an employee's income and employment-tax wages unless the cost of the assistance would qualify as a deductible, job-related expense of the employee if the employee had incurred the expense directly.

Administration's Recommendation

As stated in the Administration's Fiscal Year 1996 budget, the Administration supports extension of the exclusion for employer-provided educational assistance on a revenue-neutral basis.

The exclusion encourages employers to provide educational assistance and thereby increase the nation's productivity. In addition, the absence of the exclusion would impose significant administrative burdens on employers, workers, and the IRS in distinguishing between job-related expenses (which are excludable from gross income under current law when paid by the employer) and other employer-provided educational expenses.

As noted above, absent the exclusion, the value of employer-provided educational assistance is excludable from gross income

only for employment-related educational expenses. Because of the breadth of prior training and current job responsibilities, employer-provided education benefits provided for higher-income, higher-skilled employees are more likely to qualify as employment-related and thus be deductible regardless of the extension of section 127. In contrast, the educational objectives of lower-income, lower-skilled employees are more likely to include associate or undergraduate degrees and training for new employment, which do not qualify for exclusion in the absence of section 127.

2. Research Tax Credit

Background

The research tax credit initially was enacted as part of the Economic Recovery Tax Act of 1981 and was scheduled to expire on December 31, 1985. The Tax Reform Act of 1986 modified the credit and extended it through December 31, 1988. The credit was further modified and extended by the Technical and Miscellaneous Revenue Act of 1988 (extension through December 31, 1989), and the Omnibus Budget Reconciliation Act of 1989 (extension through December 31, 1990), which also modified the method for calculating a taxpayer's base amount. The credit was subsequently extended by the Omnibus Budget Reconciliation Act of 1990 (extension through December 31, 1991), the Tax Extension Act of 1991 (extension through June 30, 1992), and the Omnibus Budget Reconciliation Act of 1993 (OBRA 1993) (retroactive extension from July 1, 1992 through June 30, 1995). The credit is currently scheduled to expire on June 30, 1995.

Current Law

The research tax credit applies on an incremental basis to a taxpayer's "qualified research expenditures" for a taxable year. The credit is equal to 20 percent of the amount by which the taxpayer's qualified research expenditures for the taxable year exceed a base amount. The base amount is the product of the taxpayer's "fixed base percentage" and the average of the taxpayer's gross receipts for the four preceding years (subject to a maximum rate of .16). The base amount cannot be less than 50 percent of the taxpayer's qualified research expenditures for the taxable year.

For most taxpayers, the fixed based percentage is the ratio of the taxpayer's qualified research expenditures to its gross receipts during the period from 1984 until 1988. For certain

"start-up companies," the fixed base percentage is determined under special rules added by OBRA 1993.[1]

Qualified research expenditures consist of (1) "in house" expenses of the taxpayer for research wages and supplies used in research, (2) certain time-sharing costs for computer use in research, and (3) 65 percent of amounts paid by the taxpayer for contract research conducted on the taxpayer's behalf. To be eligible for the credit, research must be undertaken for the purpose of discovering information which is technological in nature, the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and must relate to functional aspects, performance, reliability or quality of a business component. Research does not qualify for the credit if it is conducted after the beginning of commercial production of the business component, if it is related to the adaptation of an existing business component to a particular customers requirements or need, or if it is related to the duplication of an existing business component from a physical examination of the component itself (or from similar information such as blueprints). Similarly, qualified research does not include efficiency surveys, market research or development, routine quality control, or research in the social sciences, arts, or humanities.

The credit does not apply to research conducted outside the United States, or to research funded by another person or governmental entity.

Administration's Recommendation

The Administration has consistently supported the research tax credit and included a proposal for its permanent extension in the 1994 budget. As indicated in the Administration's budget for Fiscal Year 1996, we continue to support the revenue-neutral extension of the research tax credit.

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[1]Under these rules, a taxpayer's fixed base percentage is set at .03 for the first five taxable years after 1993 in which the taxpayer incurs qualified research expenditures. For the next five years (assuming extension of the credit), the fixed base percentage is phased-in based on the taxpayer's actual ratio of qualified research expenditures to gross receipts. Thereafter, the percentage is based entirely upon the taxpayer's actual ratio for any five years selected by the taxpayer from its fifth through tenth taxable years after 1993.

Prior to amendment by OBRA 1993, a start-up company's fixed base percentage was set at .03 for all years.

The Administration recognizes the importance of technology to our national ability to compete in the global marketplace. Fostering the development of new technology is a cornerstone of our economic and national security strategy. We are committed to working with the private sector to enhance the role that technology plays in promoting competitiveness, creating high-wage jobs, maintaining America's defense capabilities, improving our quality of life, and fostering sustainable development.

The research tax credit is one tool that could be useful in supporting and fostering American technology. The credit provides incentives for private-sector investment in research and innovation that can help increase America's economic competitiveness and enhance U.S. productivity. These incentives are particularly important, as the U.S. economy becomes increasingly reliant on technological know-how, because private-sector investment in research often creates benefits for the economy that are not captured by an individual company.

The Administration continues to believe that for the research tax credit to be most effective, it should be made permanent, to provide taxpayers with greater certainty in making long-range business plans. It is also important that the cost of any extension of the research tax credit be fully offset. Increasing the Federal deficit could have an adverse impact on research expenditures (by drawing capital away from private-sector investments) and could thus offset the benefits resulting from the extension of the research tax credit.

3. Orphan Drug Tax Credit

Background

An orphan drug tax credit was first enacted as a part of the Orphan Drug Act of 1983. The Act's purpose was to provide incentives and direct Federal grant support for developing drugs for rare diseases and conditions. In addition to the incentive of a 50 percent credit for the expenses of clinically testing drugs for rare diseases, the Act also provided a seven-year exclusive marketing period for rare disease drugs approved for use by the Food and Drug Administration (FDA).

Under the 1983 Act, a "rare disease or condition" was defined as any disease or condition which occurs so infrequently in the United States that there is no reasonable expectation that the cost of developing and making available in the United States a drug for such disease or condition will be recovered from sales in the United States. This facts-and-circumstances test proved difficult to administer and, as a part of the Tax Reform Act of 1986, the definition was expanded to include any disease or condition which affects less than 200,000 persons in the United States.

This credit was originally scheduled to expire at the end of 1987, but was subsequently extended to the end of 1990 by the 1986 Act; to the end of 1991 by the Omnibus Budget Reconciliation Act of 1990; to June 30, 1992 by the Tax Extension Act of 1991; and to December 31, 1994 by the Omnibus Budget Reconciliation Act of 1993.

Since the inception of the orphan drug program, FDA has made (through March 31, 1995) 598 designations of orphan drugs related to particular diseases or conditions (some drugs have been designated with respect to more than one disease or condition). Of these orphan drugs, 104 have been approved for marketing. Included among the diseases and conditions for which marketing approval has been given are metastatic renal cell carcinoma; advanced adenocarcinoma of the ovary; tuberculosis infections; intractable spasticity caused by spinal cord injury or diseases; and hairy cell leukemia. About 20 percent of the approved drugs are to treat children.

Current Law

Prior to its expiration at the end of 1994, the orphan drug tax credit equaled 50 percent of qualified clinical testing expenses for drugs being tested under an exemption for a rare disease or condition under section 505(i) of the Federal Food, Drug, and Cosmetic Act. The testing must occur after the drug is designated under section 526 of the Act and before the drug is approved for use. Expenses funded by a government grant or by any person other than the taxpayer do not qualify. Qualified clinical testing expenses are taken into account in determining base period research expenses, but not qualified research expenses for purposes of the credit for increasing research activities (the R&E credit). The orphan drug tax credit can offset regular income tax liabilities entirely, but cannot be used to reduce alternative minimum tax liabilities. Amounts normally deductible as a business expense are reduced by the amount of any credit claimed. The credit cannot be claimed by any corporation that has elected the section 936 possessions tax credit.

Administration's Recommendation

As indicated in the Administration's Fiscal Year 1996 budget, the Administration supports making the orphan drug tax credit permanent, subject to identifying acceptable revenue offsets for any package of extensions, and will work with the Congress to achieve that goal. As a complement to other provisions of the Orphan Drug Credit Act, this credit, as noted above, has been helpful in making new drugs for rare diseases and conditions available to the least fortunate among us, those suffering from rare diseases but whose numbers are insufficient to provide adequate market incentives for developing remedial

drugs. If this provision is extended, one option to consider is making the credit permanent, so that developers of potential new drugs, when they make initial commitments of venture capital, can plan on the credit being in place if their research is successful to the point of securing FDA approval for clinical trials. The Administration would be willing to consider allowing excess orphan drug credits to be carried forward or backward, as a means to allow smaller drug firms to take advantage of this provision.

4. Full Fair-Market Value Deduction for Gifts of Qualified Appreciated Stock

Background

In the Deficit Reduction Act of 1984, Congress enacted section 170(e)(5), which provided a full fair-market value deduction for gifts of qualified appreciated stock to private foundations. At the time section 170(e)(5) was enacted, taxpayers who donated appreciated property to private foundations were permitted a deduction for their adjusted basis in the property plus sixty percent of the appreciation. This benefit for property other than qualified appreciated stock was eliminated as part of the Tax Reform Act of 1986. The House report accompanying the qualified appreciated stock legislation explained that improved treatment for gifts of all kinds to private foundations was warranted to acknowledge "the substantial role of nonoperating foundations in private philanthropy." It added that the publicly traded stock proposal was appropriate because it offered little potential for abuse.

The full fair-market value deduction for gifts of publicly traded stock expired on December 31, 1994.

Current Law

Prior to its expiration, section 170(e)(5) allowed a taxpayer who contributed qualified appreciated stock to a private foundation to deduct the full fair market value of the contributed stock, rather than the adjusted basis of the contributed stock. Qualified appreciated stock is defined as stock for which a market quotation is readily available and which has been held for more than one year (i.e., long-term capital gain property). This special treatment applies only to the extent that the qualified appreciated stock does not exceed 10 percent of the total outstanding stock of the corporation.

Section 170(e)(5) is an exception to the general rules on gifts of appreciated property to private foundations, which currently allow a deduction only for the donor's adjusted basis in the contributed property. By contrast, the rules on gifts of appreciated property to public charities generally allow a deduction for the full fair-market value of contributed long-term

capital gain property. (If a donor gives appreciated tangible personal property to a public charity which does not use it to further its exempt purposes, a deduction is allowed only for the donor's adjusted basis in the property.)

Administration's Recommendation

As set forth in the Administration's budget for Fiscal Year 1996, the Administration recommends reinstating the full fair market value deduction for gifts of qualified appreciated stock to private foundations, provided that it can be done on an acceptable revenue-neutral basis.

Private foundations perform an important role in the charitable sector. They provide grants and funding for charitable projects that they believe are promising. Thus, encouraging the formation and funding of private foundations through the full fair-market value deduction for gifts of qualified appreciated stock works to the benefit of the charitable sector as a whole.

Allowing a full fair-market value deduction for gifts of publicly traded stock to private foundations encourages taxpayers to devote the stock exclusively to charitable purposes. As government is restructured and reduced in size, the charitable sector will be expected to take on an increasing number of publicly beneficial projects. This incentive for charitable giving will help prepare for that future.

5. Targeted Jobs Tax Credit

Background

The TJTC was enacted by the Revenue Act of 1978 as a substitute for what had been a broad-based new jobs tax credit. Congress concluded that the unemployment rate had declined sufficiently so that it was appropriate to focus employment incentives on individuals with high unemployment rates and other groups with special employment needs.

The credit initially was scheduled to expire on December 31, 1981 and applied to wages earned in the first and second years of employment. The first-year credit was equal to 50 percent of the first $6,000 earned by a TJTC-hire and the second-year credit was 25 percent of the first $6,000 earned.

The TJTC has been extended on a short-term basis numerous times over the years. Revisions also have been made by a number of tax laws to adjust the amount of the credit, close loopholes, and alter the targeted groups of individuals covered by the credit.

The TJTC was amended and extended for one year through December 31, 1982, by the Economic Recovery Tax Act of 1981. This Act eliminated retroactive certification of employees already on the payroll and also required that one targeted group -- cooperative education students -- be economically disadvantaged in order to be covered by the credit. Without this constraint, employers were able to receive subsidies for hiring individuals they likely would have hired in the absence of the credit. Other changes made by the 1981 Act included increasing the number of targeted groups and modifying certain restrictions on eligibility within existing categories.

The TJTC was extended for two more years through December 31, 1984, by the Tax Equity and Fiscal Responsibility Act of 1982. This Act extended the credit to employers hiring economically disadvantaged 16- and 17-year-olds for summer employment. The 1982 Act also deleted one of the targeted groups -- former public service employment participants under the Comprehensive Employment and Training Act.

The Deficit Reduction Act of 1984 extended the TJTC for another year through December 31, 1985, after which it expired. It was extended retroactively for three more years through December 31, 1988, by the Tax Reform Act of 1986. The 1986 Act reduced the amount of the credit to 40 percent of the first $6,000 earned and eliminated the second-year credit. Employees also were required to work for a minimum of 90 days or 120 hours to be covered by the credit (14 days or 20 hours for summer youths). A minimum employment period was imposed to limit the "churning" of employees by some employers. "Churning" involves maximizing the amount of credit by rapidly turning over workforce to hire additional targeted members.

The Omnibus Budget Reconciliation Act of 1987 eliminated the credit for wages paid to individuals who perform duties similar to those of workers who are participating in or are affected by a strike or lockout. The Technical Corrections and Miscellaneous Revenue Act of 1988 extended the credit for an additional year through December 31, 1989; reduced the summer youth credit from 85 percent to 40 percent of the first $3,000 earned; and eliminated 23- and 24-year-olds from the targeted group of economically disadvantaged youths.

The TJTC was extended for nine more months through September 30, 1990, by the Omnibus Budget Reconciliation Act of 1989. This Act also reduced the burden placed on local Employment Service offices of verifying worker eligibility. The 1989 Act required employers requesting certification of a job applicant for which there had not been a written preliminary determination of eligibility (a voucher) to specify at least one, but not more than two, targeted groups to which the individual might belong. The employer also had to certify that it had made a good faith

effort to determine the individual's eligibility. The prior practice of asking local Employment Service offices to verify TJTC-eligibility of all new hires burdened these offices without creating new jobs. The employer firms already had decided to hire the individuals, although the individuals had not yet been put on the payroll.

The Omnibus Budget Reconciliation Act of 1990 retroactively extended the TJTC for 15 months through December 31, 1991. The conference agreement also clarified the definition of one of the targeted groups. This group -- "ex-convicts" -- was defined to include persons who are placed on probation by State courts without a finding of guilty. The TJTC was further extended for six months through June 30, 1992, by the Tax Extension Act of 1991.

Most recently, the credit was extended retroactively for 30 months by the Omnibus Budget Reconciliation Act of 1993. The 1993 Act extended the TJTC to cover individuals who begin work for an employer after June 30, 1992 and before January 1, 1995.

Current Law

Before its expiration, a TJTC was available to employers for up to 40 percent of the first $6,000 of wages paid to a certified worker in the first year of employment. This translates into a potential credit of $2,400 per targeted worker. The worker must be employed for at least 90 days or work at least 120 hours. (The credit for summer youth is 40 percent of the first $3,000 of wages, or $1,200, and these individuals must work for 14 days or 20 hours.) The employer's deduction for wages is reduced by the amount of the TJTC.

Certified workers must be economically disadvantaged or disabled individuals in one of nine targeted groups. These groups are (1) youth 18-22 years old; (2) summer youth age 16-17; (3) cooperative-education students age 16-19; (4) ex-offenders; (5) Vietnam-era veterans; (6) vocational rehabilitation referrals; and individuals receiving (7) general assistance, (8) Supplemental Security Income, or (9) Aid to Families with Dependent Children.

For purposes of the TJTC, a worker is economically disadvantaged if the worker's family income is 70 percent or less of the "lower living standard income level." This level is revised periodically to account for changes in the Consumer Price Index and varies by geographic and urban area.

To claim the credit for an employee, an employer must receive a written certification that the employee is a targeted group member. Certifications for employees are generally provided by State Employment Security Agencies. The employer

must have received or filed a written request for a certification on or before the date a targeted member begins work. If the employer has received a written preliminary determination that the employee is a member of a targeted group, the employer may file a written certification request within five calendar days after the targeted group member begins work.

The TJTC is jointly administered by the Treasury Department through the Internal Revenue Service (IRS) and the Department of Labor through its Employment Service. The IRS is responsible for tax-related aspects of the program and the Employment Service, through the network of State Employment Security Agencies, is responsible for defining and documenting worker eligibility.

Administration's Recommendation

The employment of economically disadvantaged and disabled workers is one of the Administration's most pressing concerns. Because we are very concerned about the efficient use of government revenues and the need to find revenue offsets, however, we believe that the problems undermining the credit's effectiveness must be addressed before pursuing an extension of the credit.

The most recent example of criticism of the program is an August 1994 report by the Labor Department's Office of Inspector General. The Inspector General's report raises significant concerns regarding the effectiveness of the credit. Although the report notes that the TJTC provides some benefits, the report concludes that the TJTC is not cost-effective and recommends that the Secretary of Labor discourage further extensions of the credit.

I would like to highlight three of the credit's main problems and offer very general options and principles for addressing those concerns. These problems are that the credit (1) provides a windfall to employers, (2) subsidizes short-term employment, and (3) promotes only limited training of employees for advanced career positions.

A. Employer windfall

Perhaps the most significant problem with the TJTC is that it often provides a "windfall" to employers. The credit provides a windfall to the extent it confers a benefit on employers for doing what they would have done without that benefit.

The most direct way to reduce any windfall is to require certification of eligibility before the hiring decision is made. In this way, the TJTC can serve as an incentive in the hiring decision. We are mindful that pre-hiring certification may be perceived as conferring a stigma on job applicants. However, the

TJTC was designed to overcome any negative employer perception about the likely productivity of targeted workers by rewarding employers for hiring them. In order for the program to work effectively, employers need to be aware that they are hiring targeted workers at the time the hiring decision is made. A pre-certification system would ensure that the credit was limited to employers that knowingly hired targeted workers.

One drawback of a pre-certification system is that it would place a larger burden on the Employment Service Agencies that perform the certifications. Treasury would be very wary, however, of endorsing any "self-certification" system under which individuals or their employers would certify targeted status with reduced oversight by government agencies. We would be concerned that such an "honor system" is too susceptible to abuse to be workable. Under the current regime, the principal checks against abuse are that Employment Agencies make the certifications and their actions are subject to audit by the Department of Labor. We believe these checks are important to curbing potential abuse and should not be replaced by more lax measures.

B. Employee turnover

Another serious criticism of the TJTC is that it subsidizes short-term positions that are less likely to promote job skills that are beneficial to more advanced job positions.

The Treasury and Labor Departments have explored two broad approaches to the churning problem. Under one approach, churning would be curbed by increasing the number of hours an employee must work with an employer before his or her wages could be taken into account in computing the credit. The current minimum employment period, which is the lesser of 90 days or 120 hours, translates into as little as three weeks of full-time work.

The other approach would "backload" the credit. Under current law, the credit is 40 percent of the first $6,000 in wages paid to a targeted individual. Under the backloading approach, the credit rate applying to wages above some threshold would be higher than the credit rate applying to the initial wages. This shifts the incentive of employers in the direction of paying higher wages and keeping their employees on the job longer.

There are possible downsides to these reform proposals, such as a reduction in the initial hiring incentive and increased administrative burdens that would need to be considered.

C. Training of employees

To the extent the TJTC influences hiring and retention decisions, it helps hard-to-employ individuals develop basic job

skills. These include such fundamental skills as showing up for work on time, taking directions from managers, asking questions when instructions are not clear, and successfully completing assigned tasks. Nevertheless, the low-wage jobs traditionally subsidized by the credit typically do not offer more extensive training that could directly serve as a springboard to more advanced job positions.

To bolster the TJTC's impact on training, the Department of Labor has suggested that the credit might be expanded to apply to individuals participating in approved "school-to-work" programs. Although it is appropriate that a broad range of options be considered, attempts to redesign the TJTC to encourage training present special challenges. Any broad training initiative in the TJTC should attempt to ensure that the credit's special emphasis on hiring economically disadvantaged individuals is retained. A broad-based training option also could lose significant revenue because of the size of the potentially eligible population.

Before extending the TJTC to school-to-work participants, it also would be necessary to understand the relationships of this possible category to existing categories and the precise criteria used in establishing eligibility. We would also need to evaluate whether redesigning the TJTC to include a new training component is allocating government resources to programs that work the best.

6. Tax Credit for Producing Fuel From Nonconventional Sources

Background

As originally enacted in 1980, the nonconventional fuels production credit was available for qualified fuels produced domestically from a well drilled or a facility placed in service before January 1, 1990, and sold to an unrelated person before January 1, 2001. In 1988, the placed-in-service date for both wells and facilities was extended to January 1, 1991. In 1990, the placed-in-service date for both wells and facilities was extended to January 1, 1993, and the production-credit sunset date was extended, so that sales of qualifying fuels occurring before January 1, 2003, would be eligible for the credit.

The Energy Policy Act of 1992 included a provision which treated biomass facilities and facilities that produce synthetic fuels from coal as being placed in service before January 1, 1993, if such facility was placed in service before January 1, 1997, pursuant to a binding written contract in effect before January 1, 1996. The 1992 act also extended the production-credit sunset date to 2008.

Current Law

Under section 29 of the tax code, certain fuels produced from nonconventional sources are eligible for a production credit equal to $3 (generally adjusted for inflation) per barrel or Btu oil barrel equivalent[2]. (For calendar year 1993, the credit is $5.76 per barrel-of-oil equivalent of qualified fuels.) Qualified fuels must be produced domestically from a well drilled before January 1, 1993; or from a facility that produces gas from biomass or that produces liquid, gaseous or solid synthetic fuels from coal (including lignite) and that is placed in service before January 1, 1997, pursuant to a written binding contract in effect before January 1, 1996.[3] The production credit is available for qualified fuels from a well sold to unrelated persons before January 1, 2003 and from a facility sold to unrelated persons before January 1, 2008.

Qualified fuels include (1) oil produced from shale and tar sands, (2) gas produced from geopressured brine, Devonian shale, coal seams, a tight formation, or biomass (i.e., any organic material other than oil, natural gas or coal (or any product thereof)), and (3) liquid, gaseous or solid synthetic fuels produced from coal (including lignite), including such fuels when used as feedstocks.

Administration's Recommendation

The Administration opposes any general extension of the placed-in-service date or the production-credit sunset date for facilities that produce gas from biomass or that produce liquid, gaseous or solid synthetic fuels from coal.

When Congress enacted the nonconventional fuels production credit in 1980, an objective was to support the development of new alternative technologies to recover oil and gas.[4] By increasing the profitability of these projects, the credit encourages investment in projects that might not have been undertaken without the tax incentive. Another objective of the credit was to encourage industries to develop alternative energy

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[2]A barrel-of-oil equivalent generally means that amount of the qualifying fuel which has a 5.8 million Btu content.

[3]In the case of a facility that produces coke or coke gas, however, this provision applies only if the original use of the facility commences with the taxpayer.

[4]Senate Report No. 96-394, 96th Congress, 1st Session, p. 87.

sources that would be competitive with conventional fuels.[5] The credit was intended to apply only for a limited period of time, however, after which Congress expected "no special incentive will be needed" because the affected industries would have matured and become competitive without government assistance over the life of the credit.[6] The 1992 extension for biomass and coal facilities was intended to be a transition rule for taxpayers with facilities that were soon to be placed in service. This transition period is now almost over and no extension is warranted.

7. Transportation Fuels Excise Tax Exemption for Fuels Used in Commercial Aviation

Background

The Omnibus Budget Reconciliation Act of 1993 (OBRA 1993) generally provided for a 4.3 cents per gallon fuels excise tax on all transportation fuels, with the exception of fuel for commercial aviation, effective October 1, 1993. Gasoline and jet fuel used in commercial aviation is subject to the tax beginning on October 1, 1995.

Current Law

OBRA 1993 imposed a permanent excise tax of 4.3 cents per gallon on: (1) all transportation fuels currently subject to the Leaking Underground Storage Tank Trust Fund ("LUST") excise tax, except for jet fuels used in commercial aviation, (2) liquefied petroleum gases currently taxable as special fuels, (3) diesel fuel used in noncommercial motorboats, and (4) compressed natural gas (CNG) used in highway motor vehicles or motorboats (at 48.54 cents per mcf). Taxable fuels include motor fuels (gasoline, diesel fuel and special motor fuels) used for highway transportation or in motorboats; gasoline used in aviation; gasoline used in off-highway non-business uses (e.g., small engines and recreational trail uses); diesel fuel used in trains; and fuels used in inland waterways transportation. Most fuel uses that are exempt from the LUST tax are exempt from this tax. OBRA 1993 provided a temporary exemption from the 4.3 cents per gallon fuels tax for gasoline and jet fuels used in commercial aviation prior to October 1, 1995.

The provision was effective on October 1, 1993 (with appropriate floor stocks taxes being imposed on that date). In addition, gasoline and jet fuel used in commercial aviation was

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[5]Ibid.

[6]Ibid.

subject to the tax beginning on October 1, 1995 (with appropriate floor stocks taxes being imposed on that date).

Revenues from this transportation fuels tax are deposited in the General Fund of the Treasury. This tax is separate from, and in addition to, any user-based excise taxes imposed on the same fuels to fund the Highway Trust Fund, the Airport and Airway Trust Fund, the Leaking Underground Storage Tank Trust Fund, the Inland Waterways Trust Fund, the Aquatic Resources Trust Fund, or the National Recreational Trails Trust Fund.

Administration's Recommendation

The Administration opposes any delay of the effective date of the 4.3 cents per gallon excise tax on fuel used in commercial aviation. No legislative action is required for this tax to go into effect.

When Congress enacted the 4.3 cents per gallon excise tax on fuels used in transportation, the effective date of the tax with respect to commercial aviation fuel was delayed from October 1, 1993, to October 1, 1995, because of concerns that the commercial airline industry generally was experiencing losses. The date certain for making the provision applicable to commercial aviation indicates that there was no intention that commercial aviation should be permanently exempted from the generally applicable excise tax on transportation fuels dedicated to the General Fund and used for deficit reduction.

An excise tax of 4.3 cents a gallon on commercial aviation fuel will not significantly affect the economic condition of the airline industry. This tax rate is well within the range over which jet fuel prices have fluctuated in recent years. During 1993 and 1994 average monthly jet fuel prices ranged from 50.7 to 61.3 cents per gallon. Moreover, we expect that airlines will pass a portion of these taxes on to passengers and shippers in the form of higher fares and rates.

The revenues and profits of the airline industry have recovered in 1993 and 1994 from recession lows. The Federal Aviation Administration reports that in fiscal year 1994, U.S. commercial airlines had operating profits of $2.6 billion and net profits of $1.2 billion. Passenger enplanements were up 8.2 percent over the prior year and revenue passenger miles up 5.5 percent. The FAA forecasts domestic enplanements to grow at an average rate of 5.8 percent per year over the 1995-97 period and at a rate of 4 percent per year over the next 12 years. International enplanements for U.S. carriers are expected to grow at a 5.8 percent annual rate over the next 12 years.

A tax on jet fuel will not affect the competitiveness of the U.S. carriers, because the tax will apply to foreign carriers

operating in the U.S. and will not apply to U.S. carriers (or foreign carriers) in their international operations.

8. Allocation of Research Expenditures

Background

U.S. persons are taxed on their worldwide income, i.e., their taxable income from both U.S. and foreign sources. To prevent double taxation of foreign-source income that may also be subject to foreign income taxes, U.S. persons may credit foreign income taxes paid against their U.S. tax liability.

The foreign tax credit is limited to the taxpayer's U.S. tax liability on its foreign-source income. Without this limitation, the U.S. effectively would subsidize higher tax rates of foreign jurisdictions by reducing a taxpayer's tax liability with respect to U.S.-source income to compensate for higher taxes imposed by foreign jurisdictions on foreign-source income. A taxpayer's foreign tax credit limitation (i.e., the ability to use its foreign tax credits) increases with the level of its foreign source income.

Consequently, a taxpayer with excess foreign tax credits (creditable foreign taxes in excess of its foreign tax credit limitation) has an obvious incentive to characterize as much income as possible as foreign source and to characterize as many deductions as possible as domestic source. In order to preserve the integrity of the foreign tax credit limitation so that foreign-source income is not taxed twice and foreign taxes do not offset the U.S. tax on U.S.-source income, it is important to accurately measure taxpayers' foreign-source income. This requires both an accurate measurement of a taxpayer's foreign source gross income, and of the deductions that are properly associated with that income.

Sections 861 and 862 provide rules for determining whether income and deductions are from U.S. or foreign sources. Prior to 1977, there were either no final regulations interpreting the expense allocation rules of sections 861 and 862, or regulations that simply restated the statutory rule with little elaboration. In 1977, Treasury issued final regulations governing the sourcing of expenses and other deductions as Treas. Reg. §1.861-8.

The 1977 regulations require research and development (R&D) expenses to be allocated among two-digit Standard Industrial Classification (SIC) code categories. R&D expenses associated with each such category are separately apportioned. R&D expenses that are incurred solely to meet the legal requirements of a particular jurisdiction and that cannot reasonably be expected to generate income (beyond *de minimis* amounts) outside that jurisdiction are allocated directly to gross income from the

geographic source that includes that jurisdiction. The remaining R&D expense is apportioned under *either* the sales method or the gross income method.

Under the sales method, thirty percent of the R&D deduction is exclusively apportioned to income arising from the geographic location where more than 50 percent of the taxpayer's R&D activities are performed. The remaining 70 percent is apportioned between U.S. and foreign source income on the basis of relative amounts of domestic and foreign- source gross sales receipts. A "look through rule" treats sales of certain controlled parties, such as foreign subsidiaries, and uncontrolled licensees as sales of the taxpayer for purposes of determining domestic and foreign gross sales receipts.

As an alternative to the sales method, a taxpayer may apportion R&D expenses based on the relative amounts of gross income from U.S. and foreign sources. Under this method, however, an exclusive allocation based on the place of performance is not permitted. As a further limitation, the portion of the R&D expenses apportioned to U.S.- and foreign-source income cannot be less than 50 percent of the amount that would be apportioned to U.S.- and foreign-source income under the sales method.

The 1977 regulations have been the subject of ten temporary modifications since 1981. A chronology of these modifications follows:

The Economic Recovery Tax Act of 1981 (ERTA) directed the Treasury to study the impact of the 1977 regulations on U.S.-based R&D and on the availability of the foreign tax credit. ERTA also suspended application of the 1977 regulations to U.S.-based R&D expenses for taxpayers' first two years beginning after August 13, 1981. During this period, 100 percent of U.S.-based R&D expenses were apportioned to U.S. source income. Expenses for foreign-based R&D were apportioned between U.S. and foreign source income under the rules of the 1977 regulations.

In 1983, Treasury published a report entitled "The Impact of the Section 1.861-8 Regulation on U.S. Research and Development." This Report described the 1977 regulations as an objective attempt to satisfy the statutory requirement that R&D be properly allocated and apportioned to domestic and foreign source income and described the ERTA regime as an incentive. The Report concluded that, compared to the 1977 regulations, the ERTA regime reduced U.S. tax liabilities of affected taxpayers by $100 to $240 million in 1982. The Report also noted that the ERTA regime had different effects on different corporations, but that the additional tax liability avoided in 1982 would (if paid) have reduced domestic R&D spending in that year by between $40 million

and $260 million. On the basis of these findings, the Report recommended a two-year extension of the ERTA regime.

The Deficit Reduction Act of 1984 extended the ERTA regime for an additional two-year period (the first two taxable years beginning after August 13, 1983).

The Consolidated Omnibus Budget Reconciliation Act of 1985 extended the ERTA regime for an additional one-year period (the first taxable year beginning after August 13, 1985).

The Tax Reform Act of 1986 suspended the 1977 regulations for one year (the first taxable year beginning after August 1, 1986) as it applied to U.S.-based R&D. During this one-year suspension, 50 percent of U.S.-based R&D expenses were exclusively apportioned to U.S. source income (a reduction from the 100 percent rule of ERTA). This 50 percent exclusive apportionment was available to taxpayers electing the gross income method, as well as the sales method of apportionment. The taxpayer's remaining R&D expense was apportioned under the 1977 regulations, except that no limitation was imposed on the use of the gross income method of apportionment with respect to the remaining U.S.-based R&D expenses.

The Technical and Miscellaneous Revenue Act of 1988 suspended the R&D regulations (which had been in effect during 1987) for a four-month period (the first four months of the first taxable year beginning after August 1, 1987), during which time 64 percent of U.S.-based R&D expenses were apportioned directly to U.S. source income and 64 percent of foreign-based R&D expenses were apportioned directly to foreign source income. This rule was codified in section 864(f). The taxpayer's remaining R&D expense was apportioned under the rules of the 1977 regulations except that, for taxpayers who elected the gross income method of apportionment, the amount apportioned to foreign source income was required to be at least 30 percent of the amount that would have been apportioned to foreign source income under the sales method. For the remaining eight months of that taxable year and the following year, the 1977 regulations were in effect.

The Omnibus Budget Reconciliation Act of 1989 reinstated Code section 864(f) for the first nine months of taxpayers' first taxable year beginning after August 1, 1989.

The Omnibus Budget Reconciliation Act of 1990 reinstated Code section 864(f) for a fifteen-month period (the last three months of the first taxable year beginning after August 1, 1989 and the first taxable year beginning after August 1, 1990).

The Tax Extension Act of 1991 extended Code section 864(f) for the first six months of the first taxable year beginning after August 1, 1991.

In 1992, Treasury issued Revenue Procedure 92-56, 92-2 C.B. 409, which administratively reinstated the provisions of Code section 864(f) for the last six months of a taxpayer's first taxable year beginning after August 1, 1991, and during the immediately succeeding taxable year.

The Omnibus Budget Reconciliation Act of 1993 (OBRA 1993) extended the provisions of Code section 864(f) for taxpayers' first taxable year (beginning on or before August 1, 1994) following the taxpayer's last taxable year to which Rev. Proc. 92-56 applies or would have applied had the taxpayer elected the benefits of that Revenue Procedure. The 1993 Act also reduced the exclusive allocation percentage from 64 percent to 50 percent. Therefore, for calendar-year taxpayers, the OBRA 1993 extension expired on December 31, 1994.

Current Law

Prior to its expiration, section 864(f) provided that fifty percent of research and development expenses (other than amounts incurred to meet certain legal requirements, and thus allocable to one geographical source) were exclusively apportioned to income sourced in the place of performance of the research. The remaining research and development expenses were apportioned on the basis of either sales or gross income, but subject to the condition that if the gross income based apportionment was used, the amount apportioned to foreign source income could be no less than 30 percent of the amount that would have been apportioned to foreign source income had the sales method been used.

Administration's Recommendation

As stated in the President's fiscal year 1996 budget, the Administration supports the revenue-neutral extension of section 864(f).

In Revenue Procedure 92-56, Treasury stated that it was undertaking a review of Treas. Reg. §1.861-8(e)(3) and further stated that, if necessary, it would propose appropriate amendments to that regulation. This Revenue Procedure also stated that the Treasury and the IRS were undertaking a review of the 1977 R&D allocation regulations. Treasury contemplates proposing new regulations in the near future that are likely to be more favorable to taxpayers than the 1977 regulations.

This concludes my prepared remarks. I would be pleased to respond to any questions that you may have at this time.

Receipts Effect of Permanent Extension of Expiring Provisions 1/

	Expiration Date	Fiscal Years 1996	1997	1998	1999	2000	1995-2000
				($'s in billions)			
Permanent Extension							
Exclusion for employer provided educational assistance 2/	12/31/94	-0.835	-0.561	-0.597	-0.627	-0.657	-3.277
Research tax credit	6/30/95	-1.108	-1.352	-1.647	-1.867	-2.048	-8.022
Research and experimentation (R&E) allocation rules 3/	8/1/94	-0.991	-0.700	-0.735	-0.771	-0.810	-4.007
Orphan drug tax credit 2/	12/31/94	-0.042	-0.034	-0.038	-0.043	-0.048	-0.205
Full fair market value deduction for gifts of qualified appreciated stock 2/	12/31/94	-0.076	-0.060	-0.065	-0.070	-0.076	-0.347
Targeted jobs tax credit 2/ 4/	12/31/94	-0.262	-0.285	-0.361	-0.449	-0.528	-1.885
Other extensions supported by Administration:							
Oil spill liability tax 2/ 5/	12/31/94	0.373	0.220	0.222	0.223	0.224	1.262
Generalized system of preferences (GSP) 2/	7/31/95	-0.602	-0.489	-0.461	-0.428	-0.431	-2.411
Environmental tax on corporate taxable income 5/	12/31/95	0.307	0.520	0.530	0.536	0.540	2.433
Other expiring provisions to be considered at the hearing:							
Nonconventional fuels production credit 6/	12/31/96	0.000	-0.020	-0.110	-0.250	-0.725	-1.105
Airline fuels excise tax exemption	10/1/95	-0.379	-0.406	-0.422	-0.431	-0.437	-2.075

Department of the Treasury
Office of Tax Analysis

1/ Actual timing of receipts effect will be determined by date of enactment. Five-year totals will generally not be affected.
2/ Assumes retroactive extension with enactment date of 10/1/95.
3/ Assumes extension for taxable years beginning after 8/1/94.
4/ Does not take into account possible program modifications.
5/ Assumes statutory caps are adjusted so as not to be binding.
6/ Credit is available for facilities placed in service before 1/1/97, pursuant to a binding contract in effect before 1/1/96.

Chairman JOHNSON. I appreciate that, because there will be some questions.

Mr. Ross, please.

STATEMENT OF DOUGLAS ROSS, ASSISTANT SECRETARY FOR EMPLOYMENT AND TRAINING, U.S. DEPARTMENT OF LABOR

Mr. ROSS. Thank you. Good morning, Madam Chairman and Members of the Committee, I will briefly summarize my testimony and then submit the full written text for the record.

As you know, the administration did not seek an extension of TJTC, the Targeted Job(s) Tax Credit Program, in its most recent form. We concluded that TJTC did not deliver on its goals. Let me emphasize, however, that that does not reflect an abandonment of the goal of TJTC. In fact, we believe that improving the job prospects of the least advantaged is more important than ever. We have seen a steady decline in the economic prospects of less advantaged workers since the TJTC was enacted in 1978.

While finding jobs for the disadvantaged has always been a challenge, increasingly the challenge is job quality. In 1992, for example, more than three-quarters of all young workers between the ages of 18 and 24 had annual earnings that were too low to support a family above the poverty level. The administration has taken a number of concrete steps to try and address that problem.

The President's Middle-Class Bill of Rights provides individual skill grants to disadvantaged workers so that they can get the skills they need to earn better living, and we are fighting to preserve and, in some cases, expand programs that have a track record of effectively serving disadvantaged young people—the summer jobs program, the Job Corps Program, and youth training efforts modeled after programs like the San Jose Center for Employment and Training. As you know, our welfare proposal also preserves funding for training to help welfare recipients make the transition to jobs.

Despite the growing problem of low-income youth and this administration's commitment to an activist role in solving it, we do not support reauthorizing the TJTC in its present form. We have not come to this conclusion lightly. It is based on literally a dozen studies, and we think if there is going to be an effort to create a new, more effective credit, it has to deal with three very serious problems of the old TJTC.

First, there was great evidence that the great majority of the tax credits under the old program were windfalls to employers who would have hired the disadvantaged target group anyway. While it is true that TJTC eligible groups do suffer from high rates of unemployment, a large fraction of them actually work, mostly in the kinds of low-wage jobs subsidized by TJTC.

Unless employers claiming TJTC subsidies hire workers that either have more significant barriers to productivity or they pay them more or they retain them longer or they invest more in their development than other employers in the normal course of business, participating firms collect a benefit with no corresponding gain to the public. Unless we change behavior, we are getting nothing for our money. In tight times like this, you cannot spend money where you get nothing for it.

Second, TJTC jobs are almost always low wage and low skill, and the typical worker does not remain at these jobs long. According to the Office of the Inspector General, the median TJTC certified worker receives less than $4,000 in total wages before losing the job or leaving their job, and 50 percent do not stay longer than 6 months, which is something you get without the credit.

Third, TJTC participation appears to have little or no effect on earning power or long-term career advancement. In other words, when you compare those who are hired with it and those who are hired without it, the earnings are roughly the same and their long-term unemployment rates are about the same. It does not have any effect on what happens to them over the long run.

Besides these formal studies, there is some pretty distressing anecdotal evidence that you need to take into consideration, if Congress is going to proceed in this area. In some cases, we found Wall Street investment banks have collected the TJTC for young new hires or for summer interns. These were not actually disadvantaged youth, but were college students or recent graduates who lived off savings and scholarships while in school, and thus qualified as "disadvantaged."

For instance, in a number of cases, recent graduates of the Harvard Business School and Wharton School of Business qualified for the TJTC. That is not what this is about. In some—I thought—pretty impressive testimony in front of Congress last year by Charlene Jackson, who is Deputy Administrator of the Texas Employment Commission, and gives some feel for what we are seeing out in the field under the old program. She detailed cases where a consulting group submitted large numbers of falsified information claiming that young people qualified as a disadvantaged family of one, when in fact they were still being supported by middle-class parents.

If the Congress decides to pursue a new tax credit program for the disadvantaged, it should structure the program to avoid some of these problems that plague TJTC.

Let me talk very briefly about four principles that we would recommend as an administration that Congress look at, if they are going to create a new credit.

First, we have got to limit the potential for abuses of the program and target it to people who really need it. To do this, we think eligibility should be based on some clear and easily documentable evidence of economic advantage.

Examples could be current or recent recipients of means tested welfare program, ex-convicts or youths enrolled in State or Federal education or job training programs for the disadvantaged or disabled workers in voc rehab programs. The key is, there is an existing agency that knows whether this is a person who qualifies, who at virtually no extra cost can certify it and say this is someone on welfare. You do not need to go through some long and complex and subject-to-fraud process to find out who they really are.

Second, we have got to deal with this employer windfall problem. All too often, employers have screened for TJTC eligibility and certified their workers only after hiring them. A promising reform in this area would be to require eligible workers to gain tax credit eligibility prior to hiring. In other words, we have got to know who

is eligible first, then if you hire them, it is a conscious act. If you just hire everybody and, after the fact, see if any of them qualify, we are not getting much for our money, and maybe we are getting nothing for our money.

Third, we have got to improve the incentive to provide longer lasting jobs under the TJTC. As I said, half of all hires remained on the job for less than 6 months. A reformed tax credit program should induce employers to provide jobs that last. An employer should receive, therefore, greater reward from the credit when they manage to retain their employees for longer than a couple of months.

Finally, we have got to improve training incentives. The TJTC does not provide enough incentive to build worker skills and thus improve their long-term outcomes. Given the importance of skills in shaping employment prospects, there is a strong case for injecting a learning component into a reformed TJTC.

Madam Chairman, we offer these principles as the starting point and we offer possible discussion between the administration and Congress, should Congress wish to pursue the design of the new tax credit. The details of the approaches discussed here have not been fixed, nor have we really done any cost estimates.

In summary, as my colleague from Treasury stated, the administration would be open to working with Congress in designing a reformed tax credit program, provided that the resources to finance a reformed credit are a supplement to existing proven investments in the disadvantaged, not a substitute.

Thank you very much.

[The prepared statement follows:]

TESTIMONY OF DOUGLAS ROSS
ASSISTANT SECRETARY OF LABOR
FOR EMPLOYMENT AND TRAINING
BEFORE THE
SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

May 9, 1995

Good morning, Madam Chairman and Members of the Subcommittee. I am pleased to have the opportunity to testify before you on the Targeted Jobs Tax Credit.

The Targeted Jobs Tax Credit (TJTC) was enacted in 1978 to improve the private sector employment prospects of disadvantaged individuals. The credit expired at the end of calendar year 1994.

As you know, the Administration did not seek an extension of TJTC in its most recent form. We concluded that TJTC did not deliver on its goals, and either needed to be reformed or discarded.

Let me emphasize, though, that we are not abandoning the goal of TJTC. Indeed, we believe improving the job prospects of the least advantaged is more important than ever.

Unfortunately, we have seen a steady decline in the economic prospects of less-advantaged workers since the TJTC was enacted in 1978. The groups targeted by the TJTC are precisely those who have suffered most from this decline. Over 11 percent of the American population received welfare payments in 1993 -- a new record, up from less than 8 percent in 1978. Unemployment rates among young, out-of-school high school graduates have increased from 8.8 percent in 1978 to 13.3 percent in 1993 -- and the situation is even worse for dropouts.

The fundamental problem has as much or more to do with job quality as with job quantity. When disadvantaged workers find jobs, their wages are typically very low, and have been dropping. The median income (in constant dollars) of families led by people aged 24 or under has declined by over one-third since 1978, and in 1992 was only $15,700 annually. In 1992, some 76% of young workers 18 to 24 had annual earnings too low to support a family above poverty. Most economists believe that the low wages and low job quality available to disadvantaged youth are a major reason why so many have dropped out of the labor force completely, and why some turn to crime.

The Administration has taken concrete steps to address these problems. Our proposed Middle-Class Bill of Rights provides individual grants to disadvantaged workers to gain needed new skills. We are fighting to preserve and in some cases to expand programs of demonstrated effectiveness in serving disadvantaged youth -- the Summer Jobs program, the Job Corps program, and youth training efforts modelled after the San Jose Center for Employment and Training. And we favor welfare reform that preserves substantial substantial funding for training and other services to help welfare recipients make the transition to private sector jobs.

However, we must take a critical look at the TJTC. We remain open to the possibility that an employment tax credit could be an important part of an effective strategy to improve the job prospects of the disadvantaged. However, the evidence strongly suggests that the TJTC has failed to achieve that goal.

Since 1978 when TJTC was first enacted, Congress has repeatedly passed extensions of the program, including retroactive extensions after the credit had expired. We do not believe that such an extension should be enacted unless the

Congress is able to provide meaningful changes to the program that hold out the strong promise of increased effectiveness. Nor do we believe that a new tax credit program should be instituted unless it includes steps to address the problems that plagued the TJTC. We would be open to working with Congress in designing a reformed tax credit program, provided that the resources to finance a reformed credit are a supplement to existing investments in the disadvantaged, not a substitute.

Let me briefly describe the program and the evidence we have regarding its effectiveness. TJTC was a nonrefundable tax credit available to employers who hire: the economically disadvantaged, including youth aged 18-22; cooperative education students 16-19 years old; ex-offenders; Vietnam-era veterans; individuals receiving general assistance, Supplemental Security Income, or Aid to Families with Dependent Children; or vocational rehabilitation referrals. Economically disadvantaged summer employees aged 16-17 were also included. The program allowed for a tax credit of 40 percent of any portion of the first $6,000 earned by a certified worker within a year of the hire, provided the employee worked at least 120 hours or 90 days. Lower limits (in dollars, credit rate, and hours) apply to summer youth employees.

Administration of the TJTC has been a joint responsibility of the Treasury Department's Internal Revenue Service and the Federal-State Employment Service system. The IRS has been responsible for administering the tax-related aspects of the program, while the State Employment Service Agencies, funded by the Department of Labor's Employment and Training Administration, has been responsible for documenting worker eligibility, vouchering and issuing certifications to employers.

Including the two studies recently issued by the OIG, there have been some twelve studies of the results of the TJTC program completed over the past 15 years. Numerous other publications on the TJTC have reviewed the findings or data of these studies. In general, the research indicates the following:

1. There is evidence that the great majority of the tax credits are windfalls to employers who would have hired the disadvantaged target group members anyway. While TJTC-eligible groups do suffer from high rates of unemployment, a large fraction of the eligible population does work--mostly in the kinds of high-turnover, low-skill jobs subsidized by TJTC. Unless employers claiming TJTC subsidies hire workers with more significant barriers to productivity, pay them more, retain them longer, or invest more in their development than other employers, participating firms collect a benefit with no corresponding gain to the public. Existing studies estimate that from 70 percent to 90 percent of TJTC certifications go to individuals who would have found jobs even in the absence of the credit. The most recent Inspector General's report projects that employers would have hired 92 percent of the individuals even if the credit had not been available.

2. TJTC jobs are almost always low-wage and low-skill, and the typical worker does not remain at these jobs long. Nationally, the OIG found that most TJTC jobs were low-skilled and entry-level, with an average hourly wage of roughly $5.15 per hour. Our own administrative data confirm these low wages. What is even more important is that TJTC jobs are typically of very short duration. The OIG found that the median TJTC-certified worker remains on the job for only about 6 months, and other research has confirmed this finding. The combination of low wages and low tenure adds up to low total earnings. According to the OIG, the median TJTC-certified worker receives about $4,000 in total wages before losing or leaving their job.

3. TJTC participation appears to have little or no effect on

earning power or long-term career advancement. A 1991 GAO report did not find substantial differences in earnings resulting from TJTC work experience when compared with work experience of other TJTC-eligible workers who were not certified under the program. According to our own analysis of Census data, there is little difference between the hourly wages of TJTC eligibles who are certified under the program and those that are not.

Some claim that the work experience gained in jobs subsidized by the credit pays off in better job prospects for the future, counterbalancing the low quality of the immediate jobs. But the evidence does not support this. A 1988 report found that even five years after participation in TJTC, the average annual earnings of minority male youth who had been certified under the program were only about $7,000 per year (1993 dollars), and those of female youth were even less. Also, the Labor Department OIG determined that 35% of TJTC participants were unemployed when they were contacted about a year and a half after entering their TJTC jobs. This compares to 38% in the year before getting the job. Again, there is little evidence of improvement due to TJTC.

Besides the evidence from formal studies, there is also anecdotal evidence on the actual workings of the TJTC in the field. Based on discussions with field personnel from the state employment security agencies (SESAs) who actually run this program, we understand that abuse of the TJTC was frequent. Sometimes abuses were due to outright fraud, and sometimes they resulted from loopholes in the program rules and the difficulty of enforcing eligibility standards. However, we believe that all these abuses raise disturbing questions about the effectiveness of the program.

To take one example, in some cases Wall Street investment banks have collected the TJTC for young new hires or for summer interns. These youth were not actually disadvantaged, but were college students or recent graduates who lived off savings and scholarships while in school, and thus qualified as "disadvantaged". In fact, some of them were recent graduates of Harvard University and Columbia University.

There have also been cases of firms which mass-produce TJTC applications. After they are hired, all youth employees are interviewed. Those who report a low income over the past 6 months are asked to fill out a TJTC application which identifies them as a family of one (i.e. not dependent on their parents). These applications are then submitted en masse to SESAs, with the expectation that they will be rubber-stamped. Upon examination, one SESA has found that the great majority of these applications raise questions as to whether the applicant is actually a "family of one". Upon further review, these middle class students are not disadvantaged -- some are graduates of expensive private universities. Often applicants and their families express amazement, when interviewed, that anyone could think them to be economically disadvantaged.

The testimony of Charlean Jackson, the Deputy Administrator of the Texas Employment Commmission, in front of Congress last year gives some feel for the extent to which this program is abused in the field. Ms. Jackson testified that "The TJTC program is one that invites fraud." She detailed cases where consulting groups submitted large amounts of falsified information claiming that young people qualified as a disadvantaged "family of one", when in fact they were still being supported by their middle-class parents.

She felt that the issue was both that the program rules were difficult to enforce, especially when mail-in certification was used, and that resources to enforce it were limited. Ms. Jackson testified that more cases of abuse could have been uncovered if Texas had the financial resources to perform additional audits.

Ms. Jackson believed TJTC abuses were so frequent that Congress should not extend the program unless a serious attempt to address these problems was made.

If the Congress pursues a new tax credit program for the disadvantaged, it should structure the program to avoid some of the problems that plagued the TJTC. I believe that a thoughtfully designed tax credit program could be an effective tool for improving the employment prospects of disadvantaged Americans. Specifically, I believe the following four principles should apply:

1. Limit the potential for abuse of the program, and target it on the truly disadvantaged. Eligibility for the credit should be based on clear and easily understandable signal of economic disadvantage. Possible examples could be current or recent recipients of means-tested welfare programs, ex-convicts, or disabled workers in vocational rehabilitation programs.

Although this step would limit the eligible population, it would also limit abuses of the program, and focus it on the truly disadvantaged. For example, it is much easier to determine if an individual has been a recent welfare recipient than it is to determine if they are truly economically disadvantaged. In the former case, only a certification from a welfare office is needed. In the latter case, extensive information is neccessary on family income, location of residence, parental support, etc.

In the case of youth, determination of whether an individual is actually "economically disadvantaged" becomes especially complex. Most young people -- whether disadvantaged or not -- go through a period of low earnings at some point when they go to college or get their first jobs. During this period it is difficult to determine whether the youth is still receiving parental support, and if so, how much. The examples given above of college students receiving the credit show the way in which the "economically disadvantaged youth" eligibility group in the TJTC program can be abused.

2. Reduce employer windfall. All too often, employers have screened for TJTC eligibility and certified their workers only after hiring them. A promising reform in this area would be to require eligible workers to gain tax credit eligibility prior to hiring. As discussed above, a number of consulting companies appear to have made it a standard practice to submit all new youth employees of a company for TJTC certification, sometimes using fraudulent means to do so. This practice ensures that the credit will not impact hiring. Any future jobs-related credit should require certification for credit eligibility prior to hiring.

3. Improve the incentive to provide long-lasting jobs under the TJTC. I have already described the low quality jobs that have been subsidized by the TJTC, in which half of all hires remained on the job for less than 6 months. Recent TJTC program rules -- which offered a substantial subsidy for only the first few months of employment -- may even have provided some incentive for rapid employee turnover in order to maximize the credit amount. The program paid employers to provide the same kinds of low-quality jobs that many eligible workers drift in and out of on their own, without subsidies. And it gave too little incentive to hire and retain workers for the long term. Research has shown that job retention -- not just initial hiring -- is one of the greatest problems for low-skill workers.

A reformed tax credit program should induce employers to provide jobs that last. Employers should receive a greater reward from the credit when they manage to retain their employees for longer than a few months. One way of doing this would be to "backload" the credit, perhaps by providing a limited credit

amount for the first few thousand dollars in wages, and then a higher credit for the next several thousand. This would reward employers who retained their workers. Another way to address this problem would be to allow the credit only for employers who retained their workers for some significant period.

4. Improve training incentives. The TJTC does not provide enough incentive to build worker skills and thus improve their long-term outcomes. Given the importance of skills in shaping employment prospects, there is a strong case for injecting a learning component into a reformed TJTC. One way to do this would be by making the work-based learning slots created in conjunction with school-to-work programs eligible for TJTC subsidies. Less ambitiously, legislative and administrative steps could be taken to make participation in TJTC more accessible for low-income school-to-work participants. Besides school-to-work, there is also the possibility of extending the TJTC credit to formal training expenses for TJTC-eligible workers. However, it could be difficult to define which training expenses would qualify.

We are prepared to discuss the design of a new tax credit program with Congress, should it wish to pursue this option. We have presented these principles here as a starting point for discussion. The details of the approaches discussed here have not been fixed, nor have we done formal analysis of the costs and benefits. Also, we have concerns that some of these approaches could have negative side effects such as increased administrative complexity which would diminish their overall effectiveness. However, we do believe that these approaches could improve the TJTC program. Of course, the Administration's position on specific proposals will depend on the overall package, and on what offset is used to finance the reauthorization.

Madam Chairman, this concludes my prepared statement. At this time I would be pleased to answer any questions that you or other Members of the Subcommittee may have.

Chairman JOHNSON. Thank you, Mr. Ross, for your excellent testimony.

Mr. Murphy.

STATEMENT OF PATRICK V. MURPHY, ACTING ASSISTANT SECRETARY FOR AVIATION AND INTERNATIONAL AFFAIRS, U.S. DEPARTMENT OF TRANSPORTATION

Mr. MURPHY. Thank you, Madam Chairman.

On behalf of the Department of Transportation, I would like to thank you for this opportunity to testify today. I would like to summarize my testimony and submit the full testimony for the record.

Two years ago, Congress imposed a 4.3-cents-per-gallon excise tax on transportation fuels, effective October 1, 1993, but temporarily exempted the airlines from paying the tax as it would have applied to aviation fuel. That statutory exemption expires September 30, 1995. Given the improving health of the airline industry and the need to reduce the Federal budget deficit, the administration believes that the exemption should not be extended. This action is also appropriate, given that the other transportation industries have paid their full share of this tax for the past 2 years.

The airlines are today in far better position than they were 2 years ago to absorb the impact of the fuel tax. At the time Congress granted the exemption, the airline industry was undergoing the worst financial crisis in its history.

In 1992, the U.S. aviation industry suffered its worst year ever, with total operating losses of $2.3 billion and net losses of $4.6 billion. The airlines at that time had accumulated over $10 billion in net losses. All major carriers except Southwest had suffered heavy losses. Several airlines, including Eastern and Pan American, had ceased operations and were liquidated during this period, and three more major airlines had filed for bankruptcy protection.

Today, the picture is significantly different. Most airlines have experienced major improvements in their financial condition. As the economy has recovered from recession, so has airline traffic. The airlines have also engaged in a major restructuring of their operations, increased efficiency, cut excess capacity, reduced unit operating costs, and enhancing their competitive strength.

In addition, the three major airlines that had been under bankruptcy protection 2 years ago have since emerged from chapter 11 proceedings. As a result, the major airlines' operating profits grew to $2.4 billion in 1994, and their net loss declined to $603 million. These trends are continuing into 1995. The majors' first-quarter operating profit increased from $85 million in 1994 to $485 million in 1995. Since the first-quarter results are normally low, owing to the extreme seasonality of airline traffic, we expect the airlines to show a strong operating and net profit for 1995.

The FAA now forecasts that the currently robust airline traffic growth will hold for the next 2 years, and then continue at a healthy 4.2-percent growth rate through 2006. The strong growth in traffic, combined with the airlines' ongoing capacity reductions, should result in higher load factors for the industry. This, in turn, should boost operating profits. In view of these factors, we are now optimistic that the airlines' net income will also continue to improve.

Wall Street analysts appear to share this positive outlook for the airlines. The emerging consensus among airline analysts is that the airline fundamentals have improved and should continue to improve. The positive fundamentals include increased traffic, restrained capacity growth, higher load factors, improving revenue performance, cost containment, and financial restructuring. These are not temporary changes.

As Michael Derchin of NatWest Securities has stated, "These are not the type of changes that affect profitability for a quarter or two, but the type that can enhance the profitability picture for this industry for the rest of the decade."

The airlines' recovery has been driven, in part, by the steady decline in fuel costs in recent years. Airline fuel costs have declined from 78-cents-per-gallon in 1990 to about 53-cents-per-gallon today. In 1990, fuel costs accounted for nearly 17 percent of total operating expenses. Last year, fuel costs were about 10.6 percent of total operating expenses.

In this perspective, the impact of a 4.3-cents-per-gallon fuel tax is now far less onerous than it was 2 years ago. Based on the latest reported data, if the tax were imposed on the 12.6 billion gallons of fuel purchased by the airlines in 1994, airline expenses would be higher by $543 million annually, an increase in operating expenses of only 0.7 percent. Moreover, we anticipate airlines will pass through some portion of the tax to passengers and shippers in the form of higher fares and rates and will adjust capacity to make service adjustments. A further reduction on the impact would result from the manner in which fuel tax expenses are handled by the airlines in calculating their income tax liability.

The 4.3-cents-per-gallon fuel tax was applicable to highway gasoline and diesel fuel, maritime fuels, general aviation and commercial aviation fuel. Only the tax on commercial aviation fuel was deferred for 2 years, the reason being to give airlines time to recover.

We have calculated the relative impact of the deficit reduction portion of the Federal excise fuel tax on railroads and motor carriers. We estimate that for 1994, the impact of deficit reduction on Class I railroads was $221 million and $1.78 billion for motor carriers and their users.

In this context, the case for extending an exemption is very difficult as a matter of fairness. Other transport modes have paid the 4.3-cents-per-gallon fuel tax for almost 2 years. By the time the commercial aviation exemption expires, motor carriers and their users alone will have paid as much as $3.5 billion over 2 years. In view of the airline industry's ongoing recovery, there is no longer any justification for granting the airlines preferential treatment compared to the other modes of transportation.

Thank you.

[The prepared statement follows:]

STATEMENT OF PATRICK V. MURPHY
ACTING ASSISTANT SECRETARY OF TRANSPORTATION
FOR AVIATION AND INTERNATIONAL AFFAIRS
BEFORE THE
HOUSE COMMITTEE ON WAYS AND MEANS
CONCERNING THE FINANCIAL CONDITION OF THE AIRLINE INDUSTRY
MAY 9, 1995

Madame Chairman and Members of the Committee, the Department of Transportation is pleased to have this opportunity to comment on the financial condition of the U.S. airline industry.

Two years ago, the airline industry was in the very earliest stages of recovery from the most severe financial crisis in its history. In 1992, the U.S. aviation industry suffered its worst year ever, with total operating losses of $2.2 billion and net losses of $4.6 billion, and had accumulated over $10 billion in net losses from 1990 through 1992. All major passenger carriers except Southwest Airlines had suffered heavy losses. Several airlines, including Eastern and Pan American--two of America's oldest and largest airlines--had ceased operations and were liquidated during this period, and three more major airlines--America West, Continental, and TWA--had filed for bankruptcy protection under Chapter 11; several more airlines were considered by industry analysts to be on the brink of bankruptcy.

I am pleased to report that today's picture is different. Most airlines have experienced improvements in their financial condition. As the economy has recovered from recession, so has airline traffic. The airlines have also engaged in a major restructuring of their operations. As a result, they have increased efficiency, cut excess capacity, reduced unit operating costs, and enhanced their competitive strength. In addition, the three major airlines that had been under bankruptcy protection two years ago have since emerged from Chapter 11 proceedings.

Historic Financial Results

Since 1985 the airlines have ridden a financial roller coaster. From 1985 through 1989, the major airlines as a group had strong net income in every year but 1986. Over the five-year period, they had cumulative net income of over $3 billion, including $1.6 billion in 1988. By the end of 1989, the major airlines had aggregate net stockholders' equity of nearly $14 billion, and long-term debt of nearly $16 billion. The airlines' debt/equity ratio stood at a fairly healthy 53/47 level.

Beginning in 1990, the airlines suffered three consecutive years of massive losses. In 1990, the major airlines lost over $3.6 billion, due primarily to Iraq's invasion of Kuwait, the subsequent Gulf War, and the consequent increase in fuel prices and decline in international airline traffic. The airlines suffered another $1.8 billion loss in 1991 as the economy slid into recession, and $4.6 billion in 1992 (including over $2 billion in one-time charges to reflect changes in the airlines' accounting of pension liabilities). By the end of 1992, the majors' long-term debt had skyrocketed to over $21 billion, and stockholders' equity had plummeted to about $9.2 billion. The industry's debt/equity ratio had climbed to 70/30.

The industry began its recovery in 1993, when the major airlines earned operating profits of $1.4 billion and net income of $454 million. Six of the nine major passenger airlines were profitable in 1993. (These figures somewhat overstate the industry's improvement, as they include "fresh start" accounting for Continental and TWA with their emergence from bankruptcy in 1993.) Although they posted a small net loss of $121.5 million, the major airlines' operating profits increased to $2.4 billion. Five of the nine major passenger airlines posted operating profits and net profits, as did both major all-cargo airlines.

Although long-term debt continued to increase in 1993, ***to $27 billion, net stockholders' equity began to recover, climbing nearly one-third to $12.3 billion.***

The industry's long-term debt declined in 1994 to $27.3 billion, and stockholders' equity grew another 30 percent to a record high of nearly $16 billion. The majors' debt/equity ratio has improved to 62/38.

The overall industry recovery during the last two years has been driven primarily by the general economic recovery from the 1991-1992 recession. In addition, carriers have been significantly aided by the rapid decline in aviation fuel costs since 1990. Because of instability in the oil markets caused by the Iraqi invasion of Kuwait, the industry's average cost of fuel jumped to nearly 78 cents per gallon in 1990. Fuel prices have declined sharply every year since then, falling to 60 cents in 1993 and to 58 cents during 1994. This steep, rapid decline in jet fuel costs has been a primary factor in the airlines' recovery over the last two years. Finally, most major carriers have restructured their operations to improve efficiency and cut costs, in order to become more competitive not only with each other but with low-cost carriers like Southwest and successful new entrants.

Since January 1992, no fewer than 30 new jet airlines have started up domestic U.S. operations, and we have authorized operations for 12 carriers who have not yet commenced service. At this moment, we have 10 more new entrant applications pending before the Department. These and other low-cost, mid-size airlines have filled a void left by the majors in point-to-point, short-haul and medium-haul city-pair markets with dramatically positive results. The larger carriers have been forced by this development to redouble their cost-cutting efforts. They have reduced service on unprofitable routes, expanded service on underserved routes, retired older, inefficient aircraft, and, in some cases, achieved new collective bargaining agreements that allow a more efficient use of labor. In order to improve the efficiency of their operations, airlines have entered into major domestic and international code-sharing and joint-marketing alliances with other carriers. Many have also restructured their debt and equipment leases to improve earnings and cash flow; others have reappraised their entire route structures and operating philosophies. In addition, management leaders at many airlines have increasingly formed partnerships with labor by encouraging employee ownership, primarily through Employee Stock Option Plans. Employees now hold an outright majority share of United, the nation's largest airline, and own large equity shares of many other airlines, including America West, Continental, Northwest, Southwest, and TWA.

These changes in the airlines' operations constitute the most comprehensive restructuring of the industry at least since the development of hub-and-spoke networks in the early and mid-1980s, and perhaps since passage of the Airline Deregulation Act in 1978.

As a result of this restructuring, most airlines have achieved dramatic improvements in their financial position. Northwest, in particular, has made enormous strides in the past two years. After suffering record losses of $386 million in 1992, it earned $81 million in 1993, and ***a record $430 million last year.*** American, America West, and United, which also suffered from heavy losses in 1992, were all solidly in the black by 1994. Southwest, which was the only profitable passenger carrier in 1992, saw its net earnings increase $180 million last year. And ValuJet, less than 2 years old, enjoyed an astounding 25 percent operating margin last year, with net income of over $20 million. Restructuring has also enabled the three major airlines formerly under Chapter 11 protection to reorganize and escape from bankruptcy. Continental emerged from bankruptcy in April 1993, TWA in November 1993, and America West in August 1994.

At the same time, the airlines' recovery has not been uniform. Despite their large aggregate operating profits, the major carriers posted net losses for 1994 of $121.5 million, and a few carriers remain in a weak financial position. Even the weaker carriers, however, have made significant progress in cutting unit costs, rationalizing their route systems, and increasing efficiency. As airline traffic increases with continued economic growth, the industry's fortunes should improve considerably.

Forecast Operating and Financial Results

The airline industry's financial prospects are critically dependent on continued airline traffic growth, which itself is a function of overall growth in economic output. Gross domestic product (GDP) grew by 3.8 percent in fiscal year 1994. At the same time, airline traffic increased by 5.5 percent, from 483 billion revenue passenger miles (RPMs) in FY 1993 to 510 billion in FY 1994.

OMB forecasts continued GDP growth of 3.1 percent in FY 1995, 2.4 percent in FY 1996, and 2.5 percent in FY 1997-2001. Thereafter, the FAA forecasts continued growth in GDP of 2.5 percent in FY 1997 to 2001, and 2.4 percent from FY 2002 through 2006. (The FAA's long-term forecast is based on a consensus of long-term growth forecasts issued by several economic analysts in the private sector.) Furthermore, the FAA forecasts that the currently robust airline traffic growth rates will continue for the next two years, and then continue at a healthy 4.2 percent through FY 2006. The FAA forecasts airline traffic of 537 billion RPMs in FY 1995, 567 billion in FY 1996, and 869 billion by FY 2006.

Most major airlines have announced plans to control or trim their capacity this year, and to continue pursuing reductions in unit costs. Continued strong growth in airline traffic, therefore, should result in higher load factors for the industry. This, in turn, should boost the airlines' operating profits, even as their real passenger yields (revenue per passenger-mile) continue to fall.

We are now optimistic that the airlines' net income should also continue to grow. Long-term debt should continue the slow decline begun in 1994, and net stockholders' equity should increase sharply.

As over the last two years, however, these benefits may not be spread evenly among the carriers. Airlines with high costs or poor route structures may continue to struggle unless they effect significant corrective steps. Highly leveraged carriers are especially vulnerable to upward pressures on interest rates. Nevertheless, we anticipate that even the weaker carriers should progress toward profitability over the next several years, albeit possibly at a slower rate than the healthier airlines.

Airline industry cost structure

The airline industry is labor-intensive. During 1994, salaries and wages accounted for 24.7 percent of the major airlines' total operating expense, and fringe benefits comprised another 9.6 percent. Total labor costs amounted to 34.3 percent of their operating expense, by far the largest expense item.

Fuel and capital costs were the next largest expense groups. The majors' fuel and oil expense was 11.0 percent of operating expense. Total equipment costs (rentals plus depreciation) were 13.7 percent of operating expense. Passenger traffic commissions are also a major airline expense, amounting to 9.4 percent of operating expense. Altogether, labor, fuel, equipment, and commission costs made up 68.4 percent of total expense in 1994.

The distribution of airline expenses has not been static over time. Fuel and oil made up nearly 23 percent of airline expense in 1985, declining to a low of 13.7 percent in 1988 before climbing again to 16.7 percent in 1990 with the Iraqi invasion of Kuwait and the attendant instability in the oil markets. Since that time, the industry's fuel cost has declined as a share of operating expense to a 10-year low of 11.0 percent in 1994.

Traffic commissions grew rapidly and nearly continuously during the last ten years, from 7.8 percent of expense in 1985 to 10.3 percent in Calendar Year 1993, an increase of one-third, before ***declining to 9.4 percent in fiscal 1994.*** Aircraft rentals have also grown from 3.5 percent in 1985 to ***8.5 percent in FY 1994.***

Labor expenses as a share of total expense have fluctuated a great deal over the last 10 years, falling from a high of 38.6 percent in 1986 to a low of 31.9 percent in 1990. They have since increased to ***34.3 percent in FY 1994.*** Depreciation has shown a

similar trend, declining from 5.5 percent in 1985 to 4.3 percent in 1990, and since then *climbing to 4.9 percent in FY 1994.*

Unit costs have also shifted over time. Total operating expense per available seat-mile (ASM) grew from a low of 7.2 cents in 1986 to a peak of nearly 9.3 cents in 1991. Since that time, total unit cost has declined somewhat *to about 9.2 cents per ASM.* Labor costs, which were 2.7 cents per ASM in 1986, have climbed steadily, reaching *nearly 3.4 cents in FY 1994.* Passenger commissions have also grown continuously and rapidly, from 0.6 cents per ASM in 1986 to nearly 1.1 cents in 1993, an increase of over 72 percent in seven years, before *declining in FY 1994 to 1.0 cents* per ASM. Equipment costs (depreciation, amortization, and rentals) have also increased, *from 0.8 cents per ASM in 1986 to nearly 1.4 cents in FY 1994.* Fuel costs, on the other hand, peaked at 1.6 cents per ASM in 1990, and have since declined *nearly one-third to less than 1.1 cents per ASM.*

By functional grouping, the airlines' largest costs were aircraft operating expense, which accounted for *40.1 percent of total operating expense in fiscal 1994.* (Aircraft operating expense consists of flying operations expense, flight equipment maintenance, and depreciation and amortization on flight equipment.) Other major functional groupings are reservations and sales expense (including commissions), which accounted for *16.6 percent* of total expense, traffic servicing at *10.3 percent*, passenger servicing at *9.4 percent*, and aircraft servicing at *6.2 percent* of operating expense. Together these five groups accounted for *82.6 percent of the airlines' operating expenses in FY 1994.*

Effect of the 4.3 cent jet fuel tax

Two years ago, Congress temporarily exempted the airlines from paying the 4.3 cents-per-gallon excise tax on jet aviation fuel. That statutory exemption expires September 30, 1995. At the time Congress granted the exemption, airlines were undergoing their worst financial crisis in history.

The industry is now in a position to accommodate this tax increase. Therefore, we do not support a further extension of the exemption. As I noted earlier, fuel costs have continued to fall, and now represent only *about 11 percent* of the industry's total operating expense. In absolute terms, fuel is now about *56 cents per gallon*, down from 78 cents in 1990 and 64 cents in 1992. In that perspective, the impact of a 4.3 cent-per-gallon fuel tax is far less onerous. *Based on the latest reported data, if the tax were imposed on the 12.1* billion gallons of jet fuel purchased by the major airlines, the airlines' fuel expense would be higher by *$543 million annually*--an increase over actual fuel expense of *7.9 percent*, but an increase in total operating expense of only *0.7 percent*.

The Department of the Treasury estimates that, for every dollar it gains from the aviation fuel tax, it loses about 25 cents in corporate income tax from the airlines. Thus, a very rough estimate of the net effect of the fuel tax on the airlines would appear to be *about $407 million*, or only about one-half of one percent of operating expense. Moreover, we anticipate that the airlines will pass through some portion of the tax onto passengers and shippers in the form of higher fares and rates. We also expect that the airlines will adjust capacity and make equipment and service adjustments to increase fuel efficiency, thus further reducing the tax's cost burden. Thus, the net impact on the industry would be substantially *less than $407 million*.

In this context, the case for extending an exemption is very difficult as a matter of fairness to other transport modes, which have paid increased excise taxes on fuel during the past two years. The Administration's position, therefore, is that there is no longer a justification for exempting the airlines from paying their fair share of energy taxes beyond the current fiscal year.

Recommendations to enhance airline profitability

Because the airline industry is hyper-sensitive to overall economic conditions, the surest road to the industry's recovery is continued economic growth. As Laura D'Andrea

Tyson, then Chair of the President's Council of Economic Advisors and now Chair of the National Economic Council, wrote last year in introducing the Administration's Initiative to Promote a Strong Competitive Aviation Industry, "A strong economy will be the best medicine for what ails the aerospace complex."

Nevertheless, as Dr. Tyson added, "a strong economy cannot alone cure these industries' ills." There is still a role for government policies to promote the financial health of the aviation industry. Two years ago, at the Administration's behest, Congress established the National Commission to Ensure a Competitive Aviation Industry to investigate the causes of the aviation industry's financial woes, and to recommend measures to speed their recovery. The Commission adopted a list of 61 recommended steps to improve the aviation and aerospace industries' viability.

In January 1994, in response to the Commission's recommendations, the Administration unveiled its Initiative to Promote a Strong Competitive Aviation Industry. The Administration adopted 49 of the Commission's recommendations. As of January 1995, the Department has taken a large number of specific administrative actions to implement these recommendations.

Among the Department's most prominent actions are the introduction of new technology and navigation rules to streamline the FAA's air traffic control, which has already significantly reduced fuel consumption and airport delays for many carriers; accelerated implementation of the Global Positioning System; and a comprehensive examination of the High Density Rule affecting the four slot-controlled airports (Kennedy, LaGuardia, O'Hare, and Washington National), in order to determine the rule's impact on airline competition, fares, and service patterns. In addition, the Department has continued to monitor closely the airlines' operating and financial results, has encouraged the entry of new airlines by removing hindrances to market entry and assuring that new carriers are not harmed by unfair competitive practices. We are also continuing to reassess the economic impact of existing regulations in order to minimize regulatory burden on the industry.

Another important way to improving airline profitability is liberalization of routes, fares, and rates. Although the domestic industry has been deregulated for over 16 years, international routes are still subject to severe restrictions in many bilateral aviation markets. Liberalization of our bilateral aviation agreements with our trading partners, therefore, is another important goal of the Administration.

To achieve this, the Administration has adopted "Open Skies" initiatives with a number of our trading partners. The most dramatic fruit of this effort was the recent signing in Ottawa of the new U.S.-Canada aviation agreement. That agreement provides for complete "Open Skies" to be phased in over three years between the U.S. and the Canadian cities of Montreal, Toronto, and Vancouver, and for immediate "Open Skies" in all other U.S.-Canada markets. The Department has just issued temporary exemption authority to six U.S. carriers to provide new service to Montreal, two airlines to Toronto, and six to Vancouver. We expect the new U.S.-Canada agreement to result in several billion dollars in new trade between the two countries.

The Administration has also aggressively pursued "Open Skies" agreements with countries overseas. In the last few weeks, the United States has initialed "Open Skies" agreements with Austria, Belgium, Denmark, Finland, Iceland, Luxembourg, Norway, Sweden, and Switzerland. In addition, the Administration is seeking to improve bilateral agreements with a number of our other trading partners, including China, Japan, Peru, Poland, and the United Kingdom.

Successful implementation of "Open Skies" or liberalized bilateral agreements will provide U.S. airlines with more opportunities to compete on an even footing for increasingly valuable international traffic. Since U.S. carriers are the most cost-efficient in the world, we are confident such opportunities will result in increased profitability recovery.

In addition to the foregoing administrative actions, the Administration has proposed draft legislation to restructure FAA's Air Traffic Control functions in a new government-owned corporation funded by user fees. This would allow for more flexible personnel and procurement policies, ensure that the ATC system is able to respond quickly and efficiently to the growth of the industry and to technological advances, and provide for the highest degree of safety.

Last year, in response to recommendations of the Airline Commission, the Administration supported provisions in proposed legislation to reform the bankruptcy laws, including changes with respect to airlines. Last October Congress enacted the Bankruptcy Reform Act of 1994 we included several of the provisions we supported. In addition, on February 15, 1995, Representative Clinger introduced legislation in H.R. 951 to liberalize the restrictions on foreign ownership of U.S. carriers. Liberalization of foreign ownership rules was included in the Commission's recommendations, and has been adopted by the Administration in its Aviation Initiative and by the Department of Transportation in its recent international aviation policy statement. The Department is reviewing H.R. 951 in light of these factors.

Conclusion

With competitive pressures exerted by low-cost carriers, every major airline has launched a program to cut costs to the bone. These programs have included withdrawal from unprofitable routes and stations, retiring inefficient aircraft, reducing food service, changing distribution channels, shifting to ticketless reservations and booking, cutting commissions, and trading labor concessions for equity stakes in the airlines. These developments reflect the major changes going on in the airline industry as it restructures itself into a more efficient, highly competitive, and low-cost service industry. When these efficiencies are combined with today's health economy, and with our ongoing efforts to promote the health of this important economic sector, we see a profitable era for airlines.

Mr. Chairman, let me once again extend my thanks for the opportunity to present the Department of Transportation's views on the current and future health of the aviation industry. I am confident that, as our economy continues to grow, as U.S. air carriers become more efficient, and as the policies the Department has proposed or has underway are implemented, the aviation industry will grow, flourish, and prosper.

Chairman JOHNSON. Thank you, Mr. Murphy. I thank the three of you for your excellent testimony.

Mr. Ross, I assume from your testimony that the Department of Labor and the administration prefers not to create a new targeted jobs tax credit program, that in fact you think it would be difficult to create a program that would meet the principles that you have laid out, and you prefer the money to go into skill grants. Is that a fair statement?

Mr. ROSS. It is clearly the priority in the President's budget. We are working to consolidate, as you know, a considerable number of these different individual programs and we are trying to integrate them into resources that disadvantaged individuals, as well as laid-off workers, can use, get control of and take some charge of their own destiny.

We do support, as was suggested by Treasury, the continuation of the exclusion fully for employers who are investing in the training of their own workers.

Chairman JOHNSON. You are really making the point that government subsidies should not be aimed just at entry into the work force, but should be aimed at the attainment of quality jobs that will better support a standard of living of which we as a nation could be proud.

Mr. ROSS. I think that is right. Most folks can get first jobs. The point is not to get stuck there. There are some groups, those long-term welfare recipients, those perhaps who are on disability who need that jump start.

Chairman JOHNSON. I appreciate that, and I think that is a very important point. I want to keep my comments limited, as I am going to ask the others to.

Ms. Beerbower, would the Treasury oppose a change in the orphan drug tax credit that would require a company to, in a sense, make good on the subsidy they received early on, if an orphan drug then does become commercially very viable, very successful?

Ms. BEERBOWER. I think we would certainly consider that.

Chairman JOHNSON. Pardon?

Ms. BEERBOWER. We would consider that.

Chairman JOHNSON. The same issue I think needs to be raised in the exclusion of educational assistance. You can go to night law school for $3,000 a year, but we give educational expenses of $5,000. In this time of constrained budgets, is this rational? Would you be interested in looking at some of those kinds of things to better reduce the cost?

Ms. BEERBOWER. Sure, we would be happy to consider them.

Chairman JOHNSON Last, it is accurate to say that your position of support on some of these tax credits is not reflected in the President's budget. In other words, the cost of extension of the R&E, research and experimentation, tax credit, the cost of extension of the orphan drug credit and the allocation rules, and so on and so forth, are not accounted for in the President's budget?

Ms. BEERBOWER. In the President's budget, we support the extension of the credits, but you are correct that there is no financing offset that is provided in the budget, for the reason that we wanted to work with this Committee and with Congress generally to pro-

vide bipartisan financing options for these extensions, and we remain willing to look at—

Chairman JOHNSON. You will be willing to work with us to find offsets in the Code that represent lower national priorities?

Ms. BEERBOWER. Definitely.

Chairman JOHNSON. We appreciate that very much, and I will look forward to your input on that specific aspect.

Mr. Murphy, your statistics in regard to the transportation industry and the equity of extension were very interesting to me. There are others on the panel who are more knowledgeable regarding that matter, and I am going to yield to them.

I will recognize Mr. Matsui, my Ranking Member.

Mr. MATSUI. Thank you, Madam Chairwoman.

I would like to ask Labor, and perhaps Treasury, questions about the TJTC. From your answer to the Chairwoman's question, Mr. Ross, it seemed to me that you really do not want to see this program continue, you would rather like to see it expire, mainly because it cannot be reformed to your specifications. Is that pretty much my understanding?

Mr. ROSS. I would say that we do believe it would be possible. We can imagine the possibility of creating a credit for the disadvantaged that is much more effective than the old one. We would be willing to engage in it, not at the cost of scarce investment dollars for the disadvantaged.

Mr. MATSUI. We are talking about $1.2 billion, and it sounds to me that you are talking about—if you talked really about the disabled, you are really talking about a different kind of credit, because this is a much broader credit.

Let me say this. I would like to see it extended, at the same time it has to be reformed before I give my assent to it. All of you raised very legitimate concerns. I looked at the Inspector General's report, and last year we had some testimony on this issue. You are absolutely right, there is no reason why a Harvard graduate or a Harvard student should be able to qualify for this particular credit. These credits really go only for 6 months or less. I think the mean worker receives only 6 months out of these jobs. It is a rotational situation.

Mr. ROSS. Congressman, I would not want you at the same time to think we are not willing and more than interested in being forthcoming, if the Congress wishes to do this. We think it is important that it be effective based on the lessons of the past, and that hopefully it represents an expansion of our commitment to help the disadvantaged, not a substitute for something that works.

Mr. MATSUI. I am wondering if it would make some sense—and maybe you are already doing this—for you to meet with Mr. Houghton and Mr. Rangel and see if you can come up with something. I think that is the only way we are going to avoid a collision at the end, if you get administration and bipartisan support out of the Committee Members. Maybe you are already doing this. I do not know that. But I would recommend that, because, frankly, we do not want to be in a position where you have reservations and you must oppose the provisions that perhaps Mr. Rangel and Mr. Houghton agree to. It would not make sense.

Mr. ROSS. We do intend, in fact, I believe we even have scheduled time to meet with them yet this week. Yes, we will follow your advice.

Ms. BEERBOWER. The same on the Treasury side.

Mr. MATSUI. Good, and I would say the same with Treasury. Obviously, with the point of making sure that the costs of this is within a range that makes some sense. One thing you may want to consider—and perhaps Mr. Houghton and Mr. Rangel are looking into this—perhaps there could be some recapture provision, have a minimum length of time one would to be able to receive this credit, and whatever time that is would be something you would determine with the two principal sponsors, and then have the provision that if that person does not complete that time, you recapture it from the business.

I mean that is one way to make sure the business thinks it through before they hire that worker, not just put somebody on and take advantage of the credit and then throw them off without a lot of thought. I think the responsibility should be on everyone's side, not only the government and the employee, but the employer has to share in this responsibility and think through the well-being of that employee, as well.

There are some things that I think we need to look at, and that would be one. Perhaps it will not work. Maybe administratively it would be too difficult, but I would hope that you would look at some of these things with the idea of trying to make it work. If you cannot, we will obviously have to make tough calls.

Mr. ROSS. We will do that.

Mr. MATSUI. I thank all of you. Thank you.

Chairman JOHNSON. Mr. Herger.

Mr. HERGER. Thank you very much, Madam Chairman.

I have some questions, if I could. The point was made I believe by both Ms. Beerbower and also you, Mr. Murphy, about the fact that it would appear that the airlines are improving now. I guess my question is, when we look at this airline industry, which for a number of years has been struggling—we have three major airlines that are just pulling themselves out of bankruptcy.—If we look at 1994, even though our GDP, gross domestic product, was growing by 3.8 percent, we do show more than a quarter-billion-dollar loss by the industry. Some $285 million I believe for 1994.

I guess my question perhaps to you, Mr. Murphy, I just wonder what the rationale is at a time when the industry has been doing so poorly, that we are imposing on it a 4.3-cents-per-gallon tax on commercial aviation. Is it the administration's feeling that we can somehow tax what has been perceived by virtually all to be a weak airline into good health?

Mr. MURPHY. Congressman, the airline industry has historically been a very cyclical industry which responds in a magnified way to swings in the economy. Now that the economy has improved and the airlines have made some very fundamental changes, we believe they are on the brink of some very good times and that they have had the benefit of $1 billion over the last 2 years in a fuel tax exemption, and we believe they are now in a position to handle that without jeopardizing in any way their recovery.

Their fuel costs are now running about 55 cents per gallon, down from 70 cents per gallon in the midseventies, just a few years ago. We think the 4-cent-per-gallon tax is something they can absorb. We think the industry can continue to recover, and this will not jeopardize the health of any one airline.

Mr. HERGER. Following up on that again, we are just barely into this year, we are just into May. We have three airlines who have restructured and it would appear that maybe they are getting on their feet again. I have to assume that these three airlines plus the others have been cutting to the bone to try to get back into solvency. Again, I have to ask the question: Do we really feel that a $400 to $500 million annual tax on fuel is somehow not going to put them back into a tailspin?

Mr. MURPHY. We do not think it will put them in a tailspin. We estimated it will represent a 0.7-percent increase in their operating expenses. That is significant, but again we do not think it is going to jeopardize the recovery that is well under way and which I think is reflected by Wall Street.

Mr. JOHNSON of Texas. Will the gentleman yield?

Mr. HERGER. Yes.

Mr. JOHNSON of Texas. Does this mean that your agency is trying to run the airline industry from Washington, DC, and are you in effect saying that taxing is good for America, even if we lose an airline?

Mr. MURPHY. No, sir. We took a position that the airlines needed tax relief 2 years ago and the airlines did get a $1 billion 2-year exemption from the fuel tax. The issue in our mind is whether they continue to need that exemption that the other modes of transportation have not gotten—

Mr. JOHNSON of Texas. It is a judgmental call on your part, without probably even talking to any of the chief executive officer's or any of the airlines.

Mr. MURPHY. Sir, we do talk to the chief executive officer's on a regular basis and clearly none of them are going to—

Mr. JOHNSON of Texas. They do not want a tax increase, do they?

Mr. MURPHY. None of them are going to support a tax increase, Congressman, no, sir.

Mr. JOHNSON of Texas. Thank you.

Mr. HERGER. Concluding, does the administration feel there is a possibility that some of these airlines who again are struggling, could perhaps result in bankruptcy?

Mr. MURPHY. We do not believe this one element could, but I also do not want to leave you with the impression, Congressman, that none of our airlines have problems. There are still two or three airlines that need to continue to restructure. As an industry, we believe they have turned the corner, we continue to have new entry into the industry, and some of our airlines are going to have a very good year this year from a profits standpoint.

Mr. HERGER. Then you are saying the administration feels that it is worth the risk at this time to impose this tax, even though there is a risk of—

Mr. MURPHY. We do not think this one item is going to drive any one airline into liquidation. There are some airlines that have problems that go well beyond this tax issue that have to do with their

fundamental costs, and they are going to have to continue to work on those.

Mr. HERGER. I hope you are correct in your assumptions. I have a major concern with what you are attempting to do. I do not think it is the right thing to do, particularly right now following the incredible loss that the airlines, as a whole, have been dealt just this last year. I also am concerned about the message that the administration is sending the businesses of our country that the minute you begin to look like you are getting your head above water, look out, because here comes the government to take more out of your pocketbook. I am very concerned about that, as well.

With that, I end my questioning, Madam Chair.

Chairman JOHNSON. Thank you, Mr. Herger.

Mr. Zimmer.

Mr. ZIMMER. Thank you.

I would like to ask Ms. Beerbower to respond to a couple of specific suggestions with respect to changes in the R&E credit on behalf of the administration. Assuming that acceptable measures to offset the cost of these proposals could be found, would the administration support providing taxpayers with a one-time election to take a flat 3-percent credit in lieu of the current incremental credit?

Ms. BEERBOWER. We would consider discussing with you the modifications of the research tax credit, but in the context that the most important thing to us about it is that it be made permanent. If in discussing modifications, issues arise as to different groups being helped, hurt or whatever, if that in any way retards making it permanent, making it permanent would be our highest priority.

On a flat rate versus an incremental rate, we have in general tried to have the credit respond to increased research, as opposed to research that would have otherwise been undertaken by the taxpayer. We see a flat credit as subsidizing research that might have otherwise occurred.

Mr. ZIMMER. Even on a one-time basis, you would not be receptive to this effort?

Ms. BEERBOWER. We would consider it, but, as I said, the highest priority of the administration is to make it permanent.

Mr. ZIMMER. Well, assuming that we can make it permanent somehow, and assuming that we can make it revenue neutral somehow, let me go on to the second suggestion. If you had a reform providing taxpayers with an opportunity to adjust their fixed base period to a fresh start approach or by allowing taxpayers to choose any consecutive 4-year period, say out of the previous 8 years as their base period, is that something you would consider?

Ms. BEERBOWER. We would consider it.

Mr. ZIMMER. Would you support it?

Ms. BEERBOWER. Your assumptions are that we have financing options and we have already made it permanent. I think at that point we would be happy to work with you to modify it.

Mr. ZIMMER. This brings me to a larger point. You said just now and before that the administration wants to work in a bipartisan manner to come out with ways to offset the cost of these extensions. We are running out of time. These extensions are about to

expire, and I would like to know whether you today have any suggestions of specific ways that we can offset the revenue loss?

Ms. BEERBOWER. We do have ideas. Again, the importance to us is the bipartisan nature of expressing our ideas, so they are not ideas that we would announce but we are happy to work with you with respect to those ideas.

Mr. ZIMMER. What exactly does that mean? Because Donna Shalala used about the same terminology when she said she wanted to work with us on Medicare, dealing with the anticipated bankruptcy of the Medicare Trust Fund. How do we get going on this bipartisan discussion?

Ms. BEERBOWER. I think one of the things that encouraged us in this way was our experience with respect to GATT, General Agreement on Tarrifs and Trade, and also just recently with the 25-percent health care deduction for the self-employed. We assembled a working group, people presented ideas for financing, the financing options were presented in a bipartisan fashion, and we thought that worked quite well. Particularly in GATT, it was a very successful effort and it was at a staff level with a working group meeting.

Mr. ZIMMER. How did that working group get put together? Who took the initiative to put together the working group?

Ms. BEERBOWER. I cannot recall in GATT. In the 25-percent health area, I think it was the Joint Committee. We are happy to take the initiative. If you take the initiative, we are happy to attend the meeting. We have ideas and we would be happy to discuss them.

Mr. ZIMMER. I just hope we get off the dime, I look forward to working with you.

Thank you very much.

Chairman JOHNSON. Mr. Levin.

Mr. LEVIN. Thank you.

Let me just ask you a question about the excise tax, because I do not really think it is quite fair to say it is a question of hitting business as soon as it is profitable. I think the question here is whether an exemption from a tax that applies to other businesses should be continued. I have an open mind on that. I think it is important that we look at it in a fair way.

Later on, there is going to be testimony that says this. Forget for a moment—though I do not think you can for more than a second—the issue of profitability within the airline industry, which I think is subject to a lot of discussion, what the longer range prospects are.

The airline industry also says you have to look at the comparative impact of taxation among various transportation modes, and I think that is true. I do not know if you have seen Carol Hallett's testimony, but she compares taxation on the various transportation industries and indicates that the airlines are already paying much more. What is the appropriate response?

I think that you would agree we have to look at the overall burden on the various transportation modes. No?

Ms. BEERBOWER. I think your point is an excellent one in terms of putting this issue in context. When Congress enacted the 4.3 cent excise tax, it was intended to apply to all methods of transpor-

tation. At that point, there was a request for a special industry exemption for the airlines to last I believe only during the 2-year period. It was Congress' intention that it apply to all modes of transportation and that this particular exemption be only for the severity of the particular problems that were being faced at that point by the airline industry.

It would be inappropriate, in considering the extension, unless Congress should decide it, rather than in considering whether or not to impose the excise tax on airlines at all, and in that kind of a discussion one would look at tax burdens on relative forms of transportation.

Mr. LEVIN. Should we not do that?

Ms. BEERBOWER. The question before us is whether to extend the exemption for the airlines.

Mr. LEVIN. But it is relevant, is it not, to look at the overall tax burden? Maybe a few years ago we did not apply it to aviation because there was an immediate crisis, so we did not need to look at the larger issue of overall burden. I would think we would have to take into account subsidies, too. I am not sure of the full picture, but do you not think it is appropriate to look at overall tax burden within the transportation industry?

Mr. MURPHY. If I could, Congressman, much of the tax on these transportation companies goes into trust funds, and then one has to look at what does it cost the Federal Government to provide the infrastructure and support for different forms of transportation. We know it is substantially lower, let us say, for the railroads than it is for airlines, where we have to provide radar, air traffic control systems, we have to provide inspectors, and security. There is a cost to the Federal Government, as well as a burden on the industries.

Mr. LEVIN. Has anyone made that analysis?

Mr. MURPHY. Yes, sir, a lot of analysis on that.

Mr. LEVIN. Why don't you send it to us.

Mr. MURPHY. Yes, sir, we will be happy to.

Mr. LEVIN. In other words, answer the question for the record of the relative tax burden and take into account subsidization.

[The following was subsequently received:]

DIRECT FEDERAL TAXES FOR SELECTED TRANSPORTATION MODES
Fiscal Year 1994
($000,000)

	Actual FY 1994			With the Aviation Fuel Tax		
Commercial Aviation	Total	Trust Fund	General	Total	Trust Fund	General
Fuel						
Deficit reduction	$ -	$ -	$ -	$ 379.0	$ -	$ 379.0
LUST	$ 12.5	$ 12.5	$ -	$ 12.5	$ 12.5	$ -
Passenger ticket	$ 4,747.0	$ 4,747.0	$ -	$ 4,747.0	$ 4,747.0	$ -
Freight waybill	$ 330.0	$ 330.0	$ -	$ 330.0	$ 330.0	$ -
International departure	$ 224.7	$ 224.7	$ -	$ 224.7	$ 224.7	$ -
Total taxes	$ 5,314.2	$ 5,314.2	$ -	$ 5,693.2	$ 5,314.2	$ 379.0
Total Revenue	$ 65,748.0			$ 65,748.0		
Taxes as a share of revenue	8.1%	8.1%	0.0%	8.7%	8.1%	0.6%
Commercial Trucking						
Fuel						
Highway Trust Fund	$ 4,392.6	$ 4,392.6	$ -	$ 4,392.6	$ 4,392.6	$ -
Deficit reduction	$ 1,752.4	$ -	$ 1,752.4	$ 1,752.4	$ -	$ 1,752.4
LUST	$ 25.1	$ 25.1	$ -	$ 25.1	$ 25.1	$ -
Tire tax	$ 357.5	$ 357.5	$ -	$ 357.5	$ 357.5	$ -
Retail sales tax 3/	$ 1,635.7	$ 1,635.7	$ -	$ 1,635.7	$ 1,635.7	$ -
Highway use tax 4/	$ 650.3	$ 650.3	$ -	$ 650.3	$ 650.3	$ -
Total taxes	$ 8,813.6	$ 7,061.2	$ 1,752.4	$ 8,813.6	$ 7,061.2	$ 1,752.4
Total revenue	$ 88,600.0			$ 88,600.0		
Taxes as a share of revenue	9.9%	8.0%	2.0%	9.9%	8.0%	2.0%
Railroads						
Fuel						
LUST	$ 2.8	$ 2.8	$ -	$ 2.8	$ 2.8	$ -
Deficit reduction	$ 190.2	$ -	$ 190.2	$ 190.2	$ -	$ 190.2
Total taxes	$ 193.0	$ 2.8	$ 190.2	$ 193.0	$ 2.8	$ 190.2
Total revenue	$ 33,007.0			$ 33,007.0		
Taxes as a share of revenue	0.6%	0.0%	0.6%	0.6%	0.0%	0.6%

Mr. Ross, let me just ask you about the targeted jobs tax credit. I so much applaud what the Secretary and you have been doing in terms of job retraining. I do think it has been somewhat an unheralded effort to this point. In terms of America's future competitiveness, what you are trying to do to restructure training and retraining I think will be more durable than a lot of other things that we are doing.

I hope we can join in a bipartisan basis to do something and do something this session. Within that context—I know you are working on the whole package, you are trying to consolidate, trying to rationalize, trying to squeeze programs, make them more effective—you are a bit hesitant to take the targeted jobs tax credit by itself. I think that is understandable.

Just briefly within your overall effort to rationalize training—and we know how to do training, and you have been a leader for years—we know how to retain in this country. What is your message on the targeted jobs tax credit, that you are willing to work to reform it, that you do not think, no matter what we do, it would be very high up on the priority list of reformation of the system? But, again, you are willing to work to make it as strong as possible? Just summarize with your expertise, and I think your unique commitment combined with Secretary Reich and this administration, where you are coming from on this.

Mr. ROSS. We believe that under any circumstances, but especially in the setting in which dollars are short, that it is critical to invest in things that have demonstrated some ability to earn a return. We all agree that moving particularly low-income young people into the mainstream of the economy has as big payoff, economic and social.

The Job Corps, we know, returns about $1.46 in benefits for every dollar invested. Can it be improved? Sure, but that is a positive return. I can show that to a taxpayer. In TJTC, we were not able to demonstrate consistently any kind of positive return on those dollars. If there is a strong desire to use the tax credit as one of the means of helping the disadvantaged, I think we all agree we have got to learn from the past and get a positive cost benefit out of it.

Second, how much we invest in it needs to be determined in the context not only of the whole budget, which I know all of you are doing, but in the context of alternative investments in the disadvantaged that have some track record. I mean, part of this is, keep what works and get rid of what does not. That is what all of us are being instructed by the electorate to do. That is the framework within which we would like to look at. We are willing to work with you, if there is a desire on the part of the Committee to do so.

Mr. LEVIN. I think there is, and we look forward to working with you.

Thank you.

Mr. ROSS. Thank you, Congressman.

Chairman JOHNSON. Just to clarify the paper that you are going to get back to us from Mr. Levin's remarks, Mr. Murphy, it would be helpful if you would clarify for us all of the government's subsidies that support the different modes of transportation, including

the Highway Trust Fund and the tax sources, so we can get a better view of the role that the government plays in supporting each of our primary transportation modes.

Mr. MURPHY. We will be happy to do that.

Chairman JOHNSON. Thank you.

Mr. Johnson.

Mr. JOHNSON of Texas. Thank you, Madam Chairman.

While you are at it, how about including the costs that the airlines pay to the various airports around the country to provide their sustenance in addition to taxes that go into a trust fund that has not been used properly.

Ms. Beerbower, you were reluctant to talk about airline taxes overall or taxes overall on transportation, because you indicated that this hearing was simply on renewing the airline exemption. However, in your testimony you talked of other things that were not part of this hearing. The oil spill liability tax, for example, which you are pushing. Can you tell me why you want that extra money and what you are going to do with it? Further, why do you intend to take the cap, the statutory cap off in your proposal?

Ms. BEERBOWER. Yes, my hesitancy to discuss the tax burden on the airline industry was a resistance to the use of the word "tax." I think the better expression, which I feel quite comfortable with, is what is the government subsidy of transportation for one industry relative to another, and not focus entirely on the taxes that are borne by those industries.

Mr. JOHNSON of Texas. It is still tax, with any name you put on it. Go ahead and use whatever term you like.

Ms. BEERBOWER. On the Oil Spill Liability Trust Fund, we support the extension of the tax. We have been looking at the current balance—

Mr. JOHNSON of Texas. The tax expired, as I recall, and in one case there was a cap of $1 billion, I believe. When the fund acquired that much money, it automatically went off. I guess it went a little below that and went back on and then ultimately expired totally. Why do we need it?

Ms. BEERBOWER Well, at the current moment you are right that the balance of the fund is in excess of $1 billion dollars slightly because of the investment return. We think that the mechanism needs to be in place because of the fluctuation of the value of the trust fund, to kick it back in should there be a large oil spill liability and the fund is reduced below $1 billion.

Mr. JOHNSON of Texas. Your proposal eliminates the cap.

Ms. BEERBOWER. Our revenue estimating eliminates the cap. It assumes the cap goes up slightly over the years. A question we would certainly be willing to consider is whether or not the $1 billion needs to be increased or not, relative to the cost of the possibility of oil spills or whether $1 billion is adequate. In any case, we think the mechanism needs to be in place to reimpose the tax quickly, should the revenues in the trust fund go below $1 billion.

Mr. JOHNSON of Texas. How is that money being used? Is that being used to offset deficits, or is it being used as it is designed? Has it been tapped recently?

Ms. BEERBOWER. Well, it is currently at $1 billion in the fund. It is my understanding that the fund is used to clean up oil spills. I do not think it goes to another purpose, but we can check on that.

Mr. JOHNSON of Texas. Has there been any deductions from it recently?

Ms. BEERBOWER. Apparently there was a Puerto Rican oil spill about 6 months ago that reduced the balance in the fund below $1 billion and triggered the tax on again.

Mr. JOHNSON of Texas. How did it trigger the tax on, if it expired last year? Why don't you let your assistant talk? I think the Committee would allow that.

Ms. BEERBOWER. This is Elizabeth Wagner, our staff assistant in charge of it.

Ms. Wagner.

Ms. WAGNER. The tax went back on as of last July because of funds that were expended—that was more than 6 months ago, obviously—for a large oil spill near Puerto Rico.

Mr. JOHNSON of Texas. Was that a U.S. ship or a Puerto Rican ship?

Ms. WAGNER I am not sure, sir. Therefore, the tax did go back on as of July 1 last year, and the tax expired as of the end of last year.

Mr. JOHNSON of Texas. There is $1 billion in the fund right now?

Ms. WAGNER. There is $1 billion in the fund right now. There are annual disbursements for smaller spills of between $100 and $200 million per year, and they anticipate that that will continue. Therefore, if the tax is not extended or—

Mr. JOHNSON of Texas. Is that real money or paper money? Is it being invested? Is it drawing interest? Is it real money or is it being used against the debt?

Ms. WAGNER. It is drawing interest, and that is why there is an excess in the fund today. The interest is going into the fund.

Mr. JOHNSON of Texas. Thank you for your testimony. I am not sure that we need to redo that one, if it is operating and functioning the way it is by itself.

Chairman JOHNSON. My understanding of what you are saying is that if there were a big oil spill off the coast of New York City and the fund was drawn down without renewal of the law, there would be no way of replenishing the fund.

Ms. BEERBOWER. That is correct.

Chairman JOHNSON. Thank you.

Mr. Collins.

Mr. COLLINS. Thank you, Madam Chairman.

Mr. Levin, you were referring to the different taxes overall in the transportation industry. A bit of information, and I know there are some other overlapping tax provisions or costs to other industries other than the airline industry as far as transportation.

If you took the laundry list of taxes that the airline industry has collected today versus the fuel it purchases and converted those taxes to per-gallon fuel tax—and this is not including the 4.3 cents per gallon that is projected to be proposed for October—the airline industry will be paying an equivalent to 52.5 cents per gallon with current taxation. As that compares to the trucking industry, it is a little over twice or 100 percent more than the trucking industry.

Compared to the railroad industry, it is better than 600 percent of what the railroad industry is paying.

Mr. LEVIN. Would the gentleman yield?

Mr. COLLINS. Yes.

Mr. LEVIN. I notice that in Ms. Hallett's testimony and that is why I think you would agree that it would be wise for us to have any comments from the administration, because I do think that is relevant, the overall burden.

Mr. COLLINS. I think the gentleman is right, and not only from the standpoint of being a Member of Congress, but also having been in the transportation business myself for some 30 years, and not in the airline business.

The passenger fee was increased when NAFTA was approved for those funds to be applied to the cost of NAFTA. The Highway Trust Fund was increased from 8 to 10 percent, with 2 years of that being applied to deficit reduction. I think the airline industry itself has paid a major portion of the tax.

Mr. Murphy, your testimony suggests that the airlines can now absorb this tax because of recent marginal improvements in their financial statements. I assume that those marginal improvements makes them tax worthy. In the eyes of the Department of Transportation, what type of profits would it take to make them creditworthy so that they would have a reduction in the cost of capital that they have to borrow for investment or borrow for operations, which would lower their cost of operation and increase their tax liability on the other end? What would you say they would have to accumulate in profits over the next few years to put them back into a creditworthy position?

Mr. MURPHY. Our view, Congressman, is that the airline industry has not just undergone some marginal improvements in profits, but that some fundamental structural changes have taken place in the industry over the last few years, and the industry is now in a position to do very well.

In terms of what level of profits are needed for the next few years to raise their credit ratings, I could not answer that question. I think I would have to defer to someone in the investment banking industry. We do know, however, that some of the firms on Wall Street are now firmly recommending that certain airlines are equities and ought to be bought by investors.

Mr. COLLINS. Would not an increase in profitability lower their cost of money, which would increase their tax liability on the other end? You say you do not take that into consideration at all?

Mr. MURPHY. I said I do not know at what point their credit ratings will increase, how much profit that would take.

Mr. COLLINS. You are just focused in on the fact that they are now beginning to improve their situation to make a profit, so that makes them taxworthy. You are not concerned about creditworthiness?

Mr. MURPHY. I do not want to mix creditworthiness and the ability to continue to defer a tax. Our view is again they are in a position to begin to pay that tax that has been deferred for 2 years.

Mr. COLLINS. When you said they are improving financially because of restructuring, is it not true that that restructuring came at the cost of a number of employees through layoffs and also a cut-

back in the purchase of equipment, which again led to layoffs in the aircraft industry? The restructuring may have helped them in one area, but it costs in another, and every time we lost an employee we also lost a tax deduction from a payroll check. Is that not true?

Mr. MURPHY. Certainly both those facts are true. If I could just clarify slightly, the employment levels in the airline industry were growing in the eighties. They have more or less leveled off in the nineties. If we look at all of the people who have left the industry and then all the people who have entered the industry, employment has been flat in the airline industry.

In addition, the airlines have postponed purchases of aircraft. That was one of the problems. There was too much capacity in the system, and we believe they have now wrung most of that excess capacity out of the system, and that is one of the reasons they will return to profitability.

Mr. COLLINS. It came at the expense of individual loss of jobs and employment, which also resulted in the loss of tax deductions through those payroll checks that would have been received by those individuals.

You are interested in the fact that the airline industry is now enjoying a low fuel cost and that this tax will only increase their operation by 0.7 percent. Is that not the figure I remember you saying?

Mr. MURPHY. Seven-tenths of 1 percent, yes, sir.

Mr. COLLINS. Seven-tenths of 1 percent. What would a 10-percent cost increase in fuel do to that operating figure of 0.7 percent?

Mr. MURPHY. I would have to run those calculations, Congressman. I could not do that in my head.

Mr. COLLINS. Well, is it not true that fuel cost is now on an upward swing?

Mr. MURPHY. Fuel has been holding in the 50-cents-per-gallon range for about the last year. Fifty-five cents per gallon is the last figure we have for domestic fuel.

Mr. COLLINS. We will hear testimony on that later.

You mentioned the CEOs. Naturally, they would not prefer to see any type of tax increase on their airline. What about the business community? Will the airline be able to pass along part of this increase to other businesses? The flying public and business executives. Is it not true that an increase in their operations will result in a decrease in their tax liability, which again will affect the revenues of the Federal Government in a different fashion?

Mr. MURPHY. It is true that a large portion of this increase will be passed on to the users of the system.

Mr. COLLINS. Which will increase the cost of their business expense, and lessen the tax liability that they will be exposed to.

Mr. MURPHY. That is true.

Mr. COLLINS. It is a never-ending cycle, is it not, kind of like getting on the beltway and trying to find the end of it.

Mr. Ross, I am not surprised to hear the administration's position on the job tax credit. I had the opportunity to discuss this particular issue with the President the other day, and we both voiced concern about the individual tax credit and how it is working.

I suggest that you look at the concentration of welfare, unemployment, and crime, and you will find it exists actually in about 5 different States or 10 cities around the country, or better than 50 percent or right at 50 percent of all of those. Businesses in the private sector are going in there at their expense, not with any kind of government subsidy, and establishing operations that will employ people, and also focus in on industry that we are losing to other parts of the world.

We have lost a lot of jobs, particularly in the area of textile and apparel. If there is any possibility through favorable tax rates to an individual to a business or manufacturer who would spend their money, take their risk and investment in those areas to create jobs without any further government involvement, I believe that is a program and a plan that would have some purpose and merit to it.

Thank you, Madam Chairman.

Chairman JOHNSON. Thank you, Mr. Collins.

Mr. Hancock briefly, and Mr. Matsui very briefly.

Mr. HANCOCK. Thank you, Madam Chairman.

Mr. Murphy, is your projection that the 4.3-cents-per-gallon tax increase will be absorbed or that some of it will be passed through to the airlines' customers? If in fact it is all passed through, would there be a reduction in their profitability?

Mr. MURPHY. If they were all passed through, we would presume that there would be somewhat less travel, because higher costs would result in less travel. Yes, their profitability could be reduced.

Mr. HANCOCK. If in fact they do not pass it all through, then their profitability is automatically reduced?

Mr. MURPHY. Yes, although we believe that when their costs go up, they will make some adjustments in the efficiency in the way in which they operate their fleet. As the cost of fuel goes up, they look for ways to continue to save fuel.

Mr. HANCOCK. Is that not a little bit on conjecture? Let me ask it this way. Is it more likely that they will continue on the road to profitability without the tax increase or with the tax increase? Which way is more likely?

Mr. MURPHY. Without the tax increase, Congressman.

Mr. HANCOCK. Then I think that answers our question, does it not? We want the airlines to get on a profitable basis. Over the past 5 years, the airline industry, the investors, the stockholders in these companies have lost $13 billion. Now, how do we get into a profitability basis to where those losses can be recovered? I think that is where we have got to go.

Since they cannot pass it all through because it decreases demand for their services, they are going to lose money. If we put the 4.3 October projections in there, they are going to lose money, more money than they are losing now. That is a long way to go to get to profitability.

I especially appreciate the statement about credit-worthiness. It seems to me, when you talk about 0.7 percent, that does not amount to much. That amounts to a whole bunch when you start talking about big business spending or borrowing money. When they borrow money, they carry it out five or six places. Seven-tenths of 1 percent is a big chunk of money. Let's get them back

on the road to profitability before we start talking about taxing them.

Mr. COLLINS. Would the gentleman yield?

Mr. HANCOCK. Certainly.

Mr. COLLINS. I believe the average fuel cost for the industry is about 12 percent of their operating costs. An upswing of 6 percent in fuel costs would nullify the 0.7 percent that the gentleman is referring to.

Mr. HANCOCK. Let's give them another 2 or 3 years before we hit them again.

Thank you.

Chairman JOHNSON. Mr. Matsui.

Mr. MATSUI. Thank you, Madam Chairwoman.

I understand that Treasury will not be here tomorrow on the R&E credit and also the 861 allocation of R&E expenses. I would like to just ask a question on the latter now.

Ms. Beerbower, in your testimony, you indicated that the Treasury Department may come up with new regulations on the 861 allocation issue that would be more favorable to the taxpayers. Could you maybe answer two questions in that respect. When do you think you might have new regulations, and does that mean we would not have to act? Second—and maybe it is premature to ask this question—what do you have in mind in terms of this being more favorable for the taxpayers?

Ms. BEERBOWER. I apologize for not being able to announce the regulations at the same time as the hearing. The timing of the issuance of the regulations should be very soon. We are in the final stages of clearance, and so we hope to issue that very soon. Whether or not that means that this Committee will want to act or not act is clearly in the judgment of the Committee.

I cannot at this point go into the details of the regulations and what they do that make them more favorable than the 1977 regulations, but certainly when they are released, we are happy to brief you and go over what changes are in them.

Mr. MATSUI. When you indicate you will be perhaps making these proposed regulations very shortly, are we talking about a matter of weeks or a matter of months or—

Ms. BEERBOWER. I wish I could always predict. I would have said a matter of days, but do not hold me to that in case there is a delay. We had hoped to release them this morning.

Mr. MATSUI. Thank you very much.

Chairman JOHNSON. I share Mr. Matsui's concern. We are the chief sponsors of the extension legislation. As soon as you are able to release them, I want to set up a briefing for the Committee, so that we can understand which of the problems in that area may need our attention.

Ms. BEERBOWER. Certainly.

Chairman JOHNSON. We will schedule that, if you will let us know as soon as possible when you could talk with us.

Ms. BEERBOWER. Certainly.

Chairman JOHNSON. Thank you.

I thank this panel for your very good testimony, right to the point. I appreciate it.

As this panel is leaving, we are going to ask Mr. Camp to join us. He was unable to get here at the beginning. Dave, if you will try to observe the 5-minute rule, because we have a very long list of people testifying today.

STATEMENT OF HON. DAVE CAMP, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MICHIGAN

Mr. CAMP. Thank you. I will be brief. I want to thank the Chair and my fellow Members.

I am here to testify in favor of H.R. 733, which is legislation that will make permanent the full deductibility for gifts of publicly traded stock to private foundations. I understand the Committee will be hearing from the Council on Foundations later today.

In the interest of time, I will not spend a lot of your time discussing the importance of foundations to our communities. I think we all understand full well the impact these foundations have. In Michigan alone just in recent years, we have had 52 private foundations that were recently founded with publicly traded stock, and their assets total more than $82 million. Their annual grant making is more than $4 million.

I would like to discuss the legislation briefly. Prior to 1984, the foundation population was about 22,000 and it was shrinking. After the 1984 Tax Code amendment which permitted living donors to deduct the full fair-market value of these gifts, the number began to rise, and by 1992 nationwide foundations had grown to 35,000, and that is increasing.

Ten years after that amendment, the provision has sunsetted. The loss of this full deduction has put at risk the formation of new foundations by living donors, and I do not believe we can let this happen.

I would also like to briefly discuss H.R. 734, which is also part of this legislative package introduced by Congressman Jacobs and myself. Specifically, H.R. 734 would permit private and community foundations to establish tax-exempt common investment funds. This legislation fixes a quirk in present law which allows common funds for other charitable organizations such as universities and other public charities, but not community foundations which are also charities.

H.R. 734 would bring these foundations an economy or efficiency of scale which would allow them to make investments which can often make the difference between a good investment and a mediocre one. They would also allow these foundations to use more profitable vehicles for their investments, and in the end that would mean the grant making would increase in our communities and the people that our communities serve would be better off.

There are currently over 450 community foundations across the United States, and in 1993 they gave over $730 million in charitable grants. They are the fastest growing segment of philanthropy today, so we must continue to encourage this growth and offer incentives we can to promote these foundations as a valuable resource to American communities.

This legislation not only gives existing foundations the opportunity to expand and increase the return on their donations, but it will also encourage the creation of other new foundations to

maintain and enhance the fabric of their communities. I encourage support of both of these pieces of legislation.

I want to close by saying that these foundations are an important part of our communities, any community, for that matter, and I would like to see our Committee do what it can to encourage and enhance their activities.

Thank you.

Chairman JOHNSON. Thank you, Mr. Camp.

I, and I imagine every Member, am keenly aware of the growing role that foundation funding is playing in helping communities to meet their most local and pressing needs, and also serving as a vehicle through which we are better able to integrate existing services by providing some muscle at the local level for a better level of integration and overcoming of some of the local turf battles that often prevent more effective services. This is an area of some concern and I appreciate your testimony.

Mr. CAMP. Thank you. I also want to thank the Chair for cosponsorship of both of those bills.

Chairman JOHNSON. Thank you.

Mr. Levin.

Mr. LEVIN. It is a matter I think we are going to spend some time on, so your participation is going to be, as usual, very important.

Mr. CAMP. Thank you.

Mr. LEVIN. Thank you.

Chairman JOHNSON. Thank you, Dave.

The next panel will come forward: Carol Hallett, president and chief executive officer of Air Transport Association; Charles Barclay, president of the American Association of Airport Executives; and William Norman, vice chairman of the Travel and Tourism Government Affairs Council. While each of you has many more things after your names, I think those introductions will do.

We will start with Carol Hallett. We do have a very long agenda, so I would ask that the lights now be employed both for those who are testifying and for those who are questioning.

Thank you.

STATEMENT OF CAROL HALLETT, PRESIDENT AND CHIEF EXECUTIVE OFFICER, AIR TRANSPORT ASSOCIATION OF AMERICA

Ms. HALLETT. Thank you, Madam Chairman and Members of the Subcommittee.

I am Carol Hallett and, as you have indicated, president and chief executive officer of the Air Transport Association of America. I am here on behalf of our member airlines which transport more than 95 percent of all passenger and cargo traffic. You have received my full testimony and I do ask that it be submitted in the record.

My testimony also represents the views of the Airline Pilots Association, the Aerospace Industries Association, and United Technologies Corp. We thank you for the opportunity to discuss the commercial aviation fuel tax that is scheduled to be imposed on October 1 of this year.

The commercial airline industry, as has been stated this morning, has collectively lost more than $13 billion since 1990. The last year of black ink was in 1989. Since 1990, nearly 250,000 U.S. airline and aircraft manufacturing employees have lost their jobs. Seven major passenger airlines have filed Chapter 11 bankruptcy, and three major U.S. airlines have ceased to exist altogether.

Many airline employees have made substantial wage and benefit concessions, and total airline industry concessions now exceed $1 billion annually. Imposition of a 4.3-cents-per-gallon jet fuel tax on our industry would invalidate these employee concessions and seriously undermine the progress made by airlines over the past few years to lower costs, increase productivity and efficiency. Some of the financially weaker carriers may not survive. As Gerald Greenwald, chairman and chief executive officer of the United Airlines recently testified; "dead companies do not pay taxes."

While the industry's losses accumulated by the billions of dollars over the past 5 years, government-imposed taxes and fees increased significantly faster than any other single airline cost. As many of our Nation's industries are reporting record profits, the airline industry, which has not had a profit since 1989, is being hit with this new tax of $527 million, in addition to the estimated $6.5 billion the airline industry already pays annually in federally mandated taxes and fees.

Charts accompanying my written testimony display the rapidly increasing excise taxes and user fees over recent years, as well as the strong relationship between airline losses and these rapidly increasing government-imposed taxes and fees during the same period.

How does the airline industry compare to other industries in transportation with regard to the federally mandated fuel taxes? The commercial trucking industry pays a Federal tax of 18.4 cents per gallon for gasoline and 24 cents for diesel fuel, while the railroad industry pays a total of 6.9 cents per gallon, as Mr. Collins indicated.

To put this into perspective, if the $6.5 billion the airline industry already pays annually in federally mandated excise taxes were instead assessed in the form of a transportation fuel tax on the fuel we buy in the United States., our industry is effectively already paying, as Mr. Collins pointed out, a 52.5-cents-per-gallon tax.

Many suggest that carriers should pass on the additional cost of these new and increased taxes by charging higher air fares. If this were possible, the industry would have done this long ago, rather than confront the numerous adverse consequences associated with losing an industrywide $13 billion.

During the past few years of widespread industry losses, airlines have not been able to raise fares to cover costs. In fact, carriers have been forced to lower their fares to attract customers. Fortunately, many in the new Congress understand the impact of a new half billion dollar tax and we appreciate their willingness not only to testify before you today, but we also greatly appreciate Representatives Collins and Dunn for their strong support in sponsoring the legislation to repeal the commercial aviation jet fuel tax.

We also appreciate the cosponsors of the bill and, more importantly, we are extremely thankful to Speaker Gingrich, to Chair-

man Shuster and the leadership of the House Transportation Committee for their broad bipartisan support. We urgently ask the Congress to continue this momentum and repeal the commercial aviation jet fuel tax.

Madam Chairman, I greatly appreciate the opportunity to appear before you today, and I would be more than happy to respond to your questions.

[The prepared statement and attachments follow:]

Statement of Carol Hallett
President and Chief Executive Officer
Air Transport Association of America
Before the Subcommittee on Oversight,
Committee on Ways and Means
On the Impact of the Commercial Aviation
Jet Fuel Tax on the Airline Industry

May 9, 1995

Madam Chairman and members of the Subcommittee, I am Carol Hallett, President and Chief Executive Officer of the Air Transport Association of America. ATA represents the major carriers of the U.S. airline industry; our members transport more than 95 percent of all passenger and cargo traffic moved on U.S. flag carriers. On behalf of our member airlines,* I appreciate the opportunity to appear before you today to discuss an expiring provision of the tax law which could have a devastating impact on the financial well-being of our industry: the commercial aviation fuel tax scheduled to be imposed on October 1 of this year.

The extreme difficulties faced by our member airlines have been piling up through more than five years of financial losses. Rarely does a day pass that I do not have a discussion with at least one of our C.E.O.'s regarding the adverse consequences this new, additional tax will have on their company. Madam Chairman and members of the Subcommittee, this commercial aviation fuel tax would be a financially crippling blow on this industry.

As you are probably aware, the commercial airline industry has collectively lost more than $13 billion since 1990. The last year of black ink was 1989, when the industry reported a $128 million net profit, slightly better than breakeven. In the intervening period, our industry lost $3.9 billion in 1990, $1.9 billion in 1991, $4.0 billion in 1992, $2.1 billion in 1993, and $285 million in 1994.

Since 1990, nearly 120,000 airline employees and 125,000 U.S. aircraft manufacturing employees have lost their jobs. Further, nearly half of our major passenger airlines have been forced to file Chapter 11 Bankruptcy, and three major U.S. airlines have ceased to exist altogether. Many airline employees whose jobs have not been eliminated have made substantial wage and benefit concessions, and total airline industry concessions now exceed one billion dollars annually. At one company, employees recently gave wage and benefit concessions totalling in excess of $4.9 billion over nearly six years, in exchange for majority ownership of the company. At other carriers, employee concessions have averaged between 10 and 14%.

At a minimum, a new Federal tax in excess of one-half billion dollars annually would invalidate these employee concessions and seriously undermine the progress made by airlines over the past few years to lower costs and increase productivity and efficiency. More likely, the distinct possibility exists that some of the financially weaker carriers simply would not survive. And, as Gerald Greenwald, Chairman and CEO of United Airlines succinctly stated recently: "Dead companies don't pay taxes."

Distressingly, while the industry's losses accumulated by the billions of dollars over the past five years, government-imposed taxes and fees increased significantly more, and significantly faster, than any other single airline cost.

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* ATA member carriers include: Alaska Airlines, Aloha Airlines, American Airlines, American Trans Air, America West Airlines, Continental Airlines, Delta Air Lines, DHL Airways, Evergreen International Airlines, Federal Express, Hawaiian Airlines, KIWI Airlines, Midwest Express, Northwest Airlines, Reeve Aleutian Airways, Southwest Airlines, Trans World Airlines, United Airlines, United Parcel Service, and USAir. ATA associate members include: Air Canada, Canadian Airlines International, and KLM-Royal Dutch Airlines.

Now, as many of our nation's industries are reporting record profits, the airline industry, which has not had a profit since 1989, is being hit with yet another tax -- a 4.3 cents per gallon fuel tax that is expected to cost the airlines more than $527 million annually. This new tax is in addition to the estimated $6.5 billion the airline industry pays annually in Federally-mandated taxes and fees. In addition to the 10% excise tax on airline tickets and a 6.25% excise tax on cargo shipments, airlines collect a $6.00 International Departure Tax, a $6.50 Customs User Fee, a $6.00 Immigration User Fee, a $1.45 Agricultural Inspection Fee and, at many airports, a $3.00 Passenger Facility Charge. These taxes and fees are in addition to the Federal and state income, local property, and other taxes which all businesses must pay.

Allow me to take a moment to illustrate the staggering increase in government-imposed taxes and fees during the past five years. In 1990, the Passenger Ticket Tax was increased from 8% to 10% as part of an overall deficit reduction package. The additional 2% was deposited directly into the general fund, not the Aviation Trust Fund, in both 1991 and 1992. The timing of this ticket tax increase, coming in the midst of a deep recession and increased fuel costs resulting from the Gulf War, came at the absolute worst time and added more than $1 billion a year to airline costs. (I would note that within twelve months of the imposition of this tax, nearly all of the bankruptcy petitions were filed and Pan Am, Eastern, and Midway Airlines ceased operations.) As a result, however, the airline industry has already made a special contribution of approximately $2 billion for Federal Budget deficit reduction.

As large as the 1990 ticket tax increase was, it is just one example of the many cost increases mandated by the Federal government during this difficult period. Listed below are examples of additional tax and fee burdens placed on the airlines during the past five years:

- 1990: As part of that same deficit reduction package, the cargo and waybill tax was increased from 5% to 6.25%. This tax cost our industry $326 million last year.
- 1990: Congress authorized the Passenger Facility Charge, which cost the airlines $851 million in 1994 alone, and more than $1.4 billion over the past three years.
- 1990: Congress authorized the Agricultural Inspection Fee, to which the airlines paid $63 million last year.
- 1993: Congress authorized an increase in the INS User Fee, from $5.00 to $6.00. This tax cost the industry $288 million last year.
- 1993: The Customs User Fee was increased from $5.00 to $6.50 to help pay for the North American Free Trade Agreement. This fee cost the airlines $295 million last year.

Ironically, with regard to NAFTA, airlines negotiate access to foreign countries through separate individual bilateral agreements. Aviation rights are not part of the NAFTA treaty, and NAFTA had absolutely no effect on U.S. carrier access to the Mexican market. Yet, airlines were asked to pay for the benefits others derive from NAFTA through this increased fee.

Madam Chairman and members of the Subcommittee, the taxes and fees listed above are only those which *increased* during the previous five years, and are in addition to those I mentioned previously. To target any single industry with such a plethora of new taxes -- as well as tax and fee increases -- at a time when cumulative industry losses total more than $13 billion would be almost comical, were it not true.

Three charts following my written testimony visually display the rapidly increasing excise taxes and user fees over recent years, as well as the strong relationship between airline losses and these rapidly increasing government-imposed taxes and fees during this same period.

You might ask, how does the airline industry compare to other transportation industries, such as the trucking and railroad industries, with regard to Federally-mandated fuel taxes? The commercial trucking industry pays a Federal tax of 18.4 cents per gallon for gasoline and 24.4 cents for diesel fuel, while the railroad industry pays a total of 6.9 cents per gallon for diesel fuel.

To put this into perspective, if the $6.5 billion the airline industry already pays annually in Federally-mandated excise taxes were instead assessed in the form of a transportation fuel tax on the fuel we buy in the U.S., our industry is effectively already paying an astonishing **52.5 cents per gallon tax!** Compare this to the commercial trucking industry's 24.4 cents, and the railroad industry's 6.9 cents per gallon. The airline industry in effect pays **115% more** than the trucking industry, and **661% more** than the railroad industry. This clearly demonstrates that the airline industry is already paying government-imposed taxes and fees well in excess of its fair share.

As John Dasburg, President and Chief Executive Officer of Northwest Airlines Corp. stated recently in an article published in the Wall Street Journal:

> **"It is not difficult to appreciate the impact of such significant [government imposed] cost increases on an industry that operates on thin margins of about 2% in its good years. These fees and taxes are not based on profits, but instead must be paid without regard to profit or loss. And because airlines price to demand rather than cost, these cost increases cannot be passed on to customers; the airlines must absorb them.**
>
> **The story of the airline industry in the '90s is a textbook example of the damage that ill-conceived tax policies can do to an industry."**

During our efforts to restrain government-imposed costs, we are repeatedly confronted with the assertion that carriers should simply pass on the additional costs of new and increased taxes by charging higher air fares. Stated simply, if this were possible, the industry would have done this long ago, rather than confront the numerous adverse consequences associated with losing an industry-wide $13 billion over five years. From an economic perspective, the culprit is price elasticity. Price elasticity of demand for air transportation measures the percent of change in air passenger demand in response to a 1% change in airline ticket price. Industry analysts and academicians have concluded that each 1% increase in airline ticket price results in a 1% *decrease* in passenger traffic. During the past few years of widespread industry losses, airlines simply have not been able to raise air fares to cover costs. In fact, carriers have been forced to lower their fares to attract customers.

The commercial airline industry is one of the most energy intensive industries in the United States, with fuel representing the second largest airline expense, next to labor. Consequently, the industry is extremely sensitive to increases in the price of fuel. Unfortunately, while the cost of fuel has been relatively stable over the past few years, the average price per gallon has begun to increase in recent months. Most analysts currently predict that prices are headed in an upward direction, with an average forecast increase of at least 8%, and possibly as high as 14%, during 1995. It should be noted that each one cent per gallon increase in the market price of fuel results in more than a $150 million increase in cost to the airline industry. For the government to increase our tax burden concurrently with an increase in the price of fuel would most certainly exacerbate the fragile airline industry recovery.

It has been nearly two years now since the Administration and Congress established the National Commission to Ensure a Strong Competitive Airline Industry. In the spring of 1993, the industry had just finished reporting what many termed "staggering losses," which at that time totaled almost $10 billion. When the Commission issued its final report to Congress and the Administration in August, 1993, one of its major conclusions was that the amount of taxes imposed on our industry has impeded our ability to return to financial health. The Commission stated:

> **"We believe those (tax) provisions violate responsible principles of common sense and good public policy and we are of the opinion changes must be made to relieve the airline industry's unfair tax burden."**

Ironically, while many in the new Congress clearly understand the industry's precarious financial situation, the Administration has yet to deal with this key aspect of the Commission's report -- the same Commission which the Administration pushed long and hard to create.

Testifying before the House Transportation and Infrastructure Subcommittee on Aviation in March of this year, Patrick Murphy, Acting Assistant Secretary of Transportation, the Administration's witness, reflected on testifying before that same committee two years prior:

"In 1992, the U.S. aviation industry suffered its worst year ever, with total operating losses of $2.2 billion and net losses of $4.6 billion... I am pleased to report that today's picture is different... The industry is now in a position to accommodate this tax increase."

Madam Chairman, if $10 billion in airline losses in 1993 is a problem, logic would have it that nearly $13 billion in cumulative losses two years later is an even larger one. Unfortunately, the Administration does not see it this way.

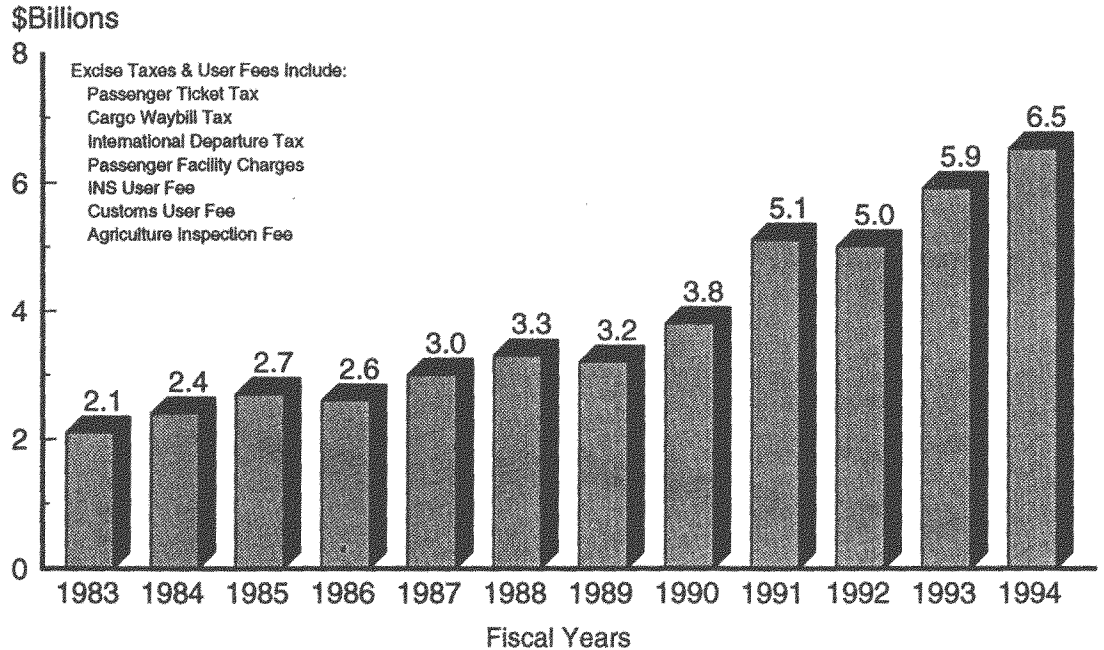
Fortunately, many in the new Congress understand with clarity the impact of a new half-billion dollar annual tax on an industry which has not made a profit since 1989. We are most grateful to you, Madam chairman, for allowing us to testify before you today. We are also very appreciative of Rep. Mac Collins (R-GA), and Rep. Jennifer Dunn (R-WA) for their strong support in sponsoring legislation, H.R. 752, to repeal the commercial aviation jet fuel tax, and to the 21 members of the Ways and Means Committee who are cosponsors of this bill. The industry is also extremely thankful to Chairman Shuster and the leadership of the House Transportation and Infrastructure Committee for their broad, bi-partisan support.

It is with these thoughts that we today urgently ask the Congress to continue this momentum and repeal the commercial aviation jet fuel tax. Repealing this tax is a necessary and critical step in creating an economic environment for a sustained airline industry recovery.

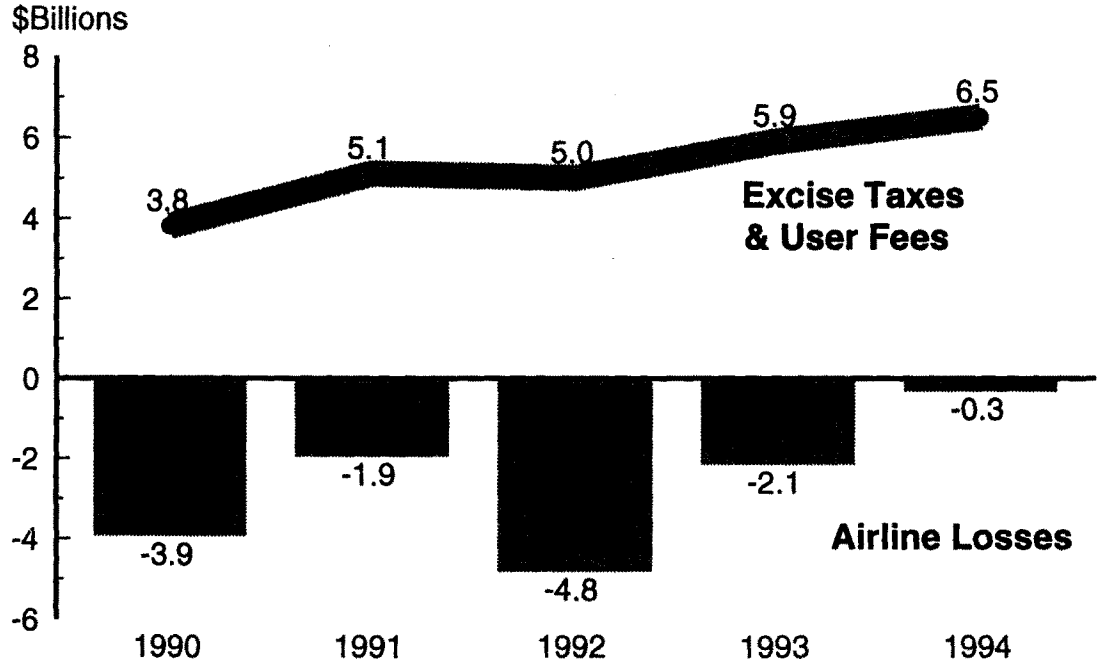
Let me close by quoting Daniel Webster, who stated nearly 175 years ago: "The power to tax is the power to destroy."

With that, Madam Chairman, I would be happy to answer any questions you or any member of the committee might have.

AIRLINE EXCISE TAXES & USER FEES RISING RAPIDLY



AIRLINE TAXES ARE RISING WHILE LOSSES CONTINUE



GOVERNMENT RELATED COSTS INCREASE FASTEST

	1988	1990	1992	1994*	ANNUAL PERCENT CHANGE
TRAFFIC & CAPACITY (Billions)					
Passenger Miles	312	325	334	345	0.9%
Available Seat Miles	508	536	533	536	1.7
Load Factor (%)	61.4	60.6	62.6	64.4	
REVENUES ($Billions)					
Yield (Cents)	12.2	13.2	12.7	13.3	1.5%
Passenger Revenue	38.1	42.9	42.2	45.7	3.2
Total Operating Revenue	42.2	47.5	46.7	51.1	3.4
EXPENSES ($Billions)					
Wages & Salaries	11.6	13.4	13.6	14.1	3.5%
Benefits	2.7	3.4	3.9	4.5	9.8
Fuel	5.7	8.6	6.6	5.8	0.2
Landing Fees	.7	.8	1.0	1.0	6.2
Passenger Food	1.4	1.7	1.8	1.6	2.4
Travel Agent Commissions	3.5	4.0	4.0	4.3	3.8
Maintenance	4.7	5.7	5.6	5.7	3.3
Advertising & Publicity	.9	1.0	.8	.7	(4.5)
All Other	9.1	10.6	11.2	11.9	4.6
Total Operating Exp	40.4	49.4	48.4	49.7	3.7
EXCISE TAXES ($Bill.)	3.189	3.701	4.759	6.190	12.2%

* 12 Months Ended Sep, 1994

Chairman JOHNSON. Thank you for your testimony.
Mr. Barclay.

STATEMENT OF CHARLES M. BARCLAY, PRESIDENT, AMERICAN ASSOCIATION OF AIRPORT EXECUTIVES AND FORMER MEMBER, NATIONAL COMMISSION TO ENSURE A STRONG COMPETITIVE AIRLINE INDUSTRY; ON BEHALF OF AIRPORTS COUNCIL INTERNATIONAL-NORTH AMERICA,

Mr. BARCLAY. Thank you, Madam Chairman.

I would like to submit my testimony and just make three brief points for the Committee.

In 1993, when the Airline Commission first got together, we asked some financial experts to come in and give us an overview of the industry, and the picture was startling even for those of us who thought we knew something about aviation. It was an industry that up to that point had lost in the preceding 3 years $10 billion. To put that in perspective, that is a larger loss than all the profits of all the airlines added together since the Wright Brothers flew.

The industry was a junk bond rated industry in its entirety, with the exception of Southwest Airlines. The major three carriers that were looked on as the strongest just a few years earlier had debt-to-equity ratios of 80 to 20 to 90 to 10. When the bankers who came in to testify before us said that they wanted to see balance sheets with 50 to 50 debt-to-equity ratios in order to loan money through normal channels to an industry like the airlines, and the airlines needed to borrow.

The last piece of this picture was an industry that needed to borrow $100 billion between 1993 and the year 2000 simply to meet the Federal noise rules for quieter aircraft and to re-equip the fleet even for the most modest projections of passenger growth.

As a result, the numbers simply did not add up and the people on the commission said, well, it also does not add up that we can run a modern economy without an airline industry in this country that at least has the financial wherewithal to attract enough capital to re-equip itself. The bar to look at is not bare profitability, it is can they make enough money to re-equip themselves.

As a result, among our 61 recommendations, we recommended that the fuel tax not go into place, that it was ill-advised at that time. Now that it is 1995, the picture has changed in that the airlines have lost $13 billion over the last 5 years, their balance sheets obviously have not improved, and they still have, according to Boeing, about an $80 billion need to invest in new aircraft between now and the year 2000. To impose this tax on the airlines in 1995 would be seriously illadvised.

The second point is that airport executives and operators are careful watchers of the airline industry. They are our partners, they are our tenants on our airports, and they are critical instruments of local economies in the communities where my members work. The airport industry is unanimous in its opinion that this ill-timed tax should not be levied on a struggling industry that is critical to our economy.

The final point I would like to make, Madam Chairman, is to ask the Members not to accept the argument, even if you are convinced on the merits of the case by the industry, you have to wake up the morning after the vote and say I did not want to do it, but the rules made me do it.

The BEA, Budget Enforcement Act, revenue offset rules have many good reasons for their existence. One of them cannot be, though, to damage a critical industry that our economy needs in the future, if we are to succeed.

Thanks very much. I would be happy to answer your questions.

[The prepared statement follows:]

STATEMENT OF CHARLES M. BARCLAY, A.A.A.
PRESIDENT, AMERICAN ASSOCIATION OF AIRPORT EXECUTIVES
ON BEHALF OF AMERICAN ASSOCIATION OF AIRPORT EXECUTIVES
AND AIRPORTS COUNCIL INTERNATIONAL-NORTH AMERICA

> "[W]e believe there are several tax provisions that impede the ability of the industry to return to financial health. We believe those provisions violate reasonable principles of common sense and good public policy and we are of the opinion changes must be made to relieve the airline industry's unfair tax burden."
>
> "Change, Challenge and Competition"
> August 1993 Report of the
> National Commission to Ensure a Strong
> Competitive Airline Industry

Madam Chairman and members of the subcommittee, my name is Charles Barclay. I am President of the American Association of Airport Executives (AAAE). I am appearing today on behalf of AAAE and the Airports Council International - North America (ACI-NA). AAAE is the professional organization representing men and women who manage primary, commercial service, reliever and general aviation airports which enplane 99 percent of the passengers in the United States. ACI-NA represents the local, state and regional governing bodies that own and operate commercial service airports in the United States, Canada and Bermuda. ACI-NA member airports serve more than 90 percent of the U.S. domestic scheduled air passenger and cargo traffic and virtually all U.S. scheduled international travel. I am also appearing today as a former member of the National Commission to Ensure a Strong Competitive Airline Industry.

We in the airport community are committed to making our nation's system of airports work efficiently, safely and economically. As such, we are keen students of our airline partners and follow with great interest all public policy issues which impact their financial health. I appear before you today to discuss the commercial aviation fuel tax

scheduled to be imposed on October 1, a government action which, if allowed to go into effect, will have severe adverse consequences on the airlines financial health as well as the financial health of airports.

Let me introduce this discussion by reviewing with you the state of play at the time the transportation fuels tax was enacted during the summer of 1993.

In the three preceding years, the airlines had lost a cumulative total of $10 billion. As a result of this terrible financial condition, Congress passed legislation to establish a National Commission to Ensure a Strong Competitive Airline Industry. I was honored to be selected to serve on the Commission.

The 4.3 cent per gallon transportation fuels tax was proposed in the Senate in June 1993, as a substitute revenue raising measure for the House-passed, broad based energy tax known as the BTU tax. Both the Btu tax and the ultimately enacted transportation fuels tax were part of an ambitious deficit reduction package. During its consideration of the transportation fuels tax, the Senate exempted commercial aviation in recognition of its financial weakness. Notwithstanding that determination, the joint House-Senate conference committee, searching for additional revenues to reach the targets which had been established, reduced the commercial aviation exemption to two-years.

In requesting that you prevent this new tax from going into effect, I suggest that you look at what has happened to the industry in the 21 months which have ensued since the adoption of the exemption and suggest that you do that in concert with a review of the Administration's response to the Commission's comments on tax policy headlined above.

In January 1994, the Administration released its "Initiative to Promote a Strong Competitive Aviation Industry" a response to the National Commission's work. Nowhere in that 23 page outline does the word "tax" appear. As a matter of fact, the Chair of the Council of Economic Advisors states in that document,

> "A strong economy will be the best medicine for what ails the aerospace complex. We believe that the recent budget reconciliation legislation, which reduces the deficit, along with other Administration initiatives, have put the economy on course for strong and sustainable growth."

So how has the "strong economy" affected the airline industry? For 1993, the industry lost $2.1 billion. For 1994, it looks like the industry will have lost another $100 million, thus bringing to five the consecutive years during which the airlines have lost money.

Bad as those results are, they do not reflect the impact of the commercial aviation fuel tax. On October 1, the imposition of this new tax will tap in excess of $500 million per year. Put another way, as the industry slowly lifts itself out of financial shambles, the fuel tax will siphon desperately needed cash from the industry, which is exactly what the National Commission articulated with reference to the fuel tax:

> "[A]t a time when the United States is looking for ways to strengthen the airline industry, an additional tax seems ill-advised."

Madam Chairman, that tax is as ill-advised today as it was in 1993. Two years after its initial consideration, the distressing economic situation which faced the industry continues. We agree that a healthy economy is a key component for airline industry profitability. Repealing the commercial aviation fuel tax is a necessary step in creating an economic environment for sustained industry recovery.

While my colleague from the carrier side, Mrs. Hallett, has spoken eloquently of the job losses in the airlines as well as the manufacturing sector, I would like to point to another potentially adverse aspect of this tax.

Airport infrastructure is financed by a blend of various user fees, such as the 10% excise tax on each ticket, Passenger Facility Charges, bonds, and fees levied on airport users, e.g. airlines and concessionaires. One of the steps airlines take when financially stressed, in addition to layoffs and deferring purchases of aircraft and engines, is to cut operating costs. To cut operating costs, carriers reduce frequencies, use smaller planes in certain localities, and pull out of marginal markets. While users pay for the airport infrastructure, it is in the marginal, smaller communities in greatest need of air service that are hit the hardest. The fuel tax increase would have the unfortunate unintended effect of penalizing marginal markets. In summary, airport executives and operators ask you not to impose this ill-timed tax on a struggling industry that clearly cannot afford it. Madam Chairman, I appreciate the opportunity to appear before you today. I will be pleased to respond to any questions you may have.

Chairman JOHNSON. Your last admonition is one we all feel keenly and we will do our best, but it is not possible simply to ignore the estimators in our work.

William Norman, please.

STATEMENT OF WILLIAM S. NORMAN, PRESIDENT AND CHIEF EXECUTIVE OFFICER, TRAVEL INDUSTRY ASSOCIATION OF AMERICA; AND VICE CHAIRMAN, TRAVEL AND TOURISM GOVERNMENT AFFAIRS COUNCIL

Mr. NORMAN. Madam Chairman and Members of the Subcommittee, on behalf of the Nation's travel and tourism industry, I appreciate the opportunity to testify before you this morning. I ask that my full testimony be placed in the record.

I am here to express the travel and tourism industry's strong support for legislative proposals that would extend the exemption of jet fuel taxes as contained in the Omnibus Reconciliation Act of 1993.

I am William Norman, president and chief executive officer of the Travel Industry Association of America. I also serve as vice chairman of the Travel and Tourism Government Affairs Council, and it is on behalf of the council and its campaign to keep travel competitive that I appear before you today.

The U.S. travel and tourism industry generated an estimated $416 billion in expenditures in 1994, which equal more than 6 percent of the Nation's GNP, gross national product. Last year, travel and tourism was once again the Nation's leading export, generating $75 billion in expenditure from 44 million international visitors, and from the 46 million Americans traveling abroad who spent $53 billion, creating a $22 billion trade surplus.

Travel and tourism directly employs 6.2 million people and ranks second only to health care in employment. State and local communities are increasingly turning to travel and tourism to grow their economies, so much so that 34 States and the District of Columbia rank travel and tourism as one of their three top employers.

While the news about the size, scope and importance of travel and tourism for the Nation's economy is positive, some in public office have come to view the travel industry as nothing more than a tax generator and have constantly sought to increase our taxes and fees, which only hampers our ability to be jobs generators.

Our specific concern here this morning is the Federal jet fuel tax exemption which expires in October of this year. In 1993, Congress recognized that the airline industry had lost billions of dollars and had been forced to lay off tens of thousands of employees. Thus, airline jet fuel was exempted from the 4.3-cents-per-gallon increase and the Federal excise tax on motor fuel.

While the most dramatic and direct effect of applying this tax to aviation fuel would be on the airline themselves, such a fuel tax increase would also have an impact on other travel segments, such as hotels, restaurants, car rentals, amusement and attractions, as well as tour companies and others whose customers fly to their destinations.

Alarmingly, should continued price competition force the air carriers to absorb part or all of this increased fuel cost, it could further erode airline profitability, leading to additional airline layoffs

and a reduction in the number of flights, which would also harm the travel industry by offering business and leisure travelers fewer travel options, especially where there is no easy substitute for air travel. Fewer flights could lead to fewer passenger trips, resulting in reduced demand for lodging, meals, retail shopping, tours and attractions.

Madam Chairman, the travel and tourism industry has learned a valuable lesson concerning the corrosive effect of excessive taxation during the past year. For example, in 1990, the New York State Legislature approved a new 5-percent surtax on all hotel rooms costing more than $100 per night. Supporters of this higher tax projected the State to realize an additional $60 or $70 million annually, with few or no negative consequences.

To the surprise of no one in the travel and tourism industry, this higher tax had a dramatically negative impact, first and foremost on the lodging industry, but also on shops, restaurants, theaters and tour companies. Most of the negative effect was felt in New York City, where lower room occupancy rates forced hotels to lay off thousands of employees. Instead of collecting more tax revenues, New York actually lost millions of dollars, as business and leisure travelers went to lower cost destinations.

We recognize that other modes of transportation are paying the additional 4.3 cents per gallon for fuel. However, it is important to note that Congress has already mandated that airlines collect specific excise taxes in lieu of fuel taxes. The Federal Government is already collecting a 10-percent tax on airline tickets, as well as an array of other taxes and user fees, including a $3 passenger facility charge at many airports. This 10-percent tax on airline flights is already too high, and now the airline industry is threatened with even more taxes.

The travel and tourism industry strongly asks that the jet fuel tax exemption be extended, especially during this year of the White House Conference on Travel and Tourism. This year, as never before, our industry is focused on seeking new ways to grow and conduct business, generate more jobs, expand our export growth and provide even better travel experience for our customers. Higher taxes on the travel industry and its customers will only hamper our ability to achieve these goals and objectives.

Thank you very much, Madam Chairman.

[The prepared statement follows:]

STATEMENT OF WILLIAM S. NORMAN
PRESIDENT AND CEO, TRAVEL INDUSTRY ASSOCIATION OF AMERICA
AND VICE CHAIRMAN TRAVEL AND TOURISM GOVERNMENT AFFAIRS COUNCIL

Madame Chairman, on behalf of the nation's travel and tourism industry, I appreciate the opportunity to testify before you this morning. I am here to express the travel and tourism industry's strong support for legislative proposals that would extend the exemption for jet fuel taxes as contained in the Omnibus Reconciliation Act of 1993.

I am William Norman, President and CEO of the Travel Industry Association of America (TIA). TIA is the national, non-profit organization representing all components of the U.S. travel and tourism industry. I also serve as Vice Chairman of the Travel and Tourism Government Affairs Council, a coalition of 36 national associations, corporations and labor organizations. An affiliate of TIA, the Council is comprised of key elements of the travel and tourism industry, including all modes of transportation, accommodations, food service, travel agents, tour sales, recreation and attractions, as well as state and local travel and tourism officials. It is on behalf of the Council, and its *Campaign to Keep Travel Competitive*, that I appear before you today. A list of the Council's membership is attached to this statement.

Importance of Travel and Tourism

The U.S. travel and tourism industry generated an estimated $416 billion in expenditures in 1994, which equaled more than 6% of the GNP. Last year travel and tourism was once again the nation's leading export, generating $75 billion in expenditures from 44 international visitors while the 46 million Americans traveling abroad spent $53 billion...creating a $22 billion trade surplus, which accounts for 40 percent of the nation's total services trade surplus. Travel and tourism is the nation's third-largest retail industry, behind automotive dealers and food stores. It directly employs nearly 6.2 million people and ranks second only to health care in employment. The industry also supports another 5.8 million jobs through indirect and induced sales.

States and local communities are increasingly turning to travel and tourism to grow their economies -- so much so that thirty-four states and the District of Columbia rank travel and tourism as one of their top three employers. Travel and tourism jobs are rapidly increasing, with industry employment in the last ten years expanding at a rate more than twice that of the rest of the economy, and forecasters tell us travel and tourism employment will grow in excess of 30 percent over the next twelve years. Increasingly, these are top quality jobs, as more than 650,000 executive jobs exist in all segments of travel and tourism today.

Extending The Jet Fuel Tax Exemption

While the news about the size, scope and importance of travel and tourism for the nation's economy is positive, an insidious factor that has significantly threatened the growth and vitality of this industry is government-imposed taxes, fees and surcharges. Travel and tourism companies and their customers are willing to pay their fair share of taxes and fees -- and in 1994 travel and tourism generated $56 billion in tax revenue for Federal, state and local governments. Unfortunately, however, some in public office have come to view this industry as nothing more than a tax-generator and have constantly sought to increase our taxes and fees, which only hampers our ability to be a jobs-generator.

Our specific concern here this morning is the Federal jet fuel tax exemption, which expires in October of this year. In 1993, Congress recognized that the airline industry had lost billions of dollars and had been forced to lay off tens of thousands of employees. Thus, airline jet fuel was exempted from the 4.3 cent increase in the Federal excise tax on motor fuel. While the most dramatic and direct impact of applying this tax to aviation fuel would be on the airlines themselves, such a fuel tax increase would also have an impact on other travel segments such as hotels, restaurants, car rentals, amusements and attractions, as tour companies and others whose customers fly to their destinations, and hundreds of cities and dozens of states whose economies are dependent on travel and tourism.

Indirect impacts on other segments of travel and tourism from a new Federal tax on aviation fuel could come in at least two different ways. If the airlines choose to pass along the total fuel cost increase of more than $500 million annually to their customers through higher ticket prices, this

could result in greatly reduced demand for flying, which would impact all the other components of travel and tourism whose customers usually fly to reach those destinations.

On the other hand, should fierce price competition force the carriers to absorb part or all of this increased fuel cost, it could lead to additional layoffs at the air lines themselves, and a reduced number of flights, which would also harm the travel industry by offering business and leisure travelers far fewer travel options where there is no easy substitute for air travel. This could easily lead to fewer trips being taken and would lead to reduced demand for lodging, meals, retail shopping, tours and attractions.

The travel and tourism industry has learned a valuable lesson concerning the corrosive effect of excessive taxation during the past few years. In 1990, the New York State Legislature approved a new 5% surcharge that applied to all hotel rooms costing more than $100 per night. This money was to be used to help reduce the state's budget deficit. Supporters of this higher tax believed the state could realize an additional $60 or $70 million annually, and that there would be no negative consequences.

To the surprise of no one in the travel and tourism industry, this higher tax had a dramatically negative impact, first and foremost on the lodging industry, but also on shops, restaurants, theaters and tour companies. Most of the impact was felt in New York City, where lower room occupancy rates forced hotels to lay off thousands of employees. Meetings and convention business fell in excess of 30% over a four year period. Instead of collecting more in tax revenue, New York officials drove business and leisure travelers to less-taxed destinations and the State of New York actually lost millions of dollars in revenue. The hotel tax surcharge was finally repealed last year, but not before the damage was done to New York's travel and tourism economy.

In the case of New York's higher taxes, you could argue that travelers at least had other options for places to visit or conduct meetings. But, if a higher Federal tax is levied on jet fuel, there will be no way to avoid the tax; especially for longer trips that require air travel. And yes, fuel costs for other modes of transportation are paying the additional 4.3 cents per gallon for fuel, but Congress had already mandated that airlines collect specific excise taxes in lieu of a fuel tax. The Federal government is already collecting a 10% tax on airline tickets, as well as an array of other taxes and user fees, including a $3.00 passenger facility charge at many airports. This 10% Federal tax on airline flights is already too high, and now the airline industry is threatened with even more taxes.

Should Members of Congress seek further counsel on this issue, they need look no further than the final report issued by the *National Commission To Ensure A Strong Competitive Airline Industry* in early 1994. The National Airline Commission called on Congress to "relieve the airline industry of its unfair tax and user fee burden." The travel and tourism industry strongly agrees and asks that the jet fuel tax exemption be extended. Especially during this year of the White House Conference on Travel and Tourism, this industry is seeking new ways to grow, new innovative ways to conduct business and provide even better travel experiences for our customers. Higher taxes on the travel industry and its customers will only hamper our ability to be a leading jobs-producer.

TRAVEL AND TOURISM GOVERNMENT AFFAIRS COUNCIL
MEMBERSHIP

MEMBERS

Air Transport Association
Airports Council International
American Automobile Association
American Car Rental Association
American Council of Highway Advertisers
American Hotel & Motel Association
American Recreation Coalition
American Sightseeing International
American Society of Travel Agents
American Travel Affairs Council, Inc.
Association of Retail Travel Agents
Gray Line Worldwide
Highway Users Federation
Hospitality Sales and Marketing Association International
International Association of Amusement Parks and Attractions
International Association of Convention and Visitor Bureaus
International Council of Cruise Lines
Meeting Professionals International
NATSO, Inc.
National Air Carrier Association
National Association of RV Parks & Campgrounds
National Business Travel Association
National Council of Area and Regional Tourism Organizations
National Council of State Travel Directors
National Council of Travel Attractions
National Council of Urban Tourism Organizations
National Park Hospitality Association
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National Tour Association
Passenger Vessel Association
Recreation Vehicle Industry Association
Society of American Travel Writers
Society of Travel Agents in Government
Travel Industry Association of America
US Tour Operators Association

MEMBERS AT LARGE

Ronald W. Allen, Delta Air Lines, Inc.
Roger H. Ballou, American Express Travel Related Services Co., Inc.
Robert H. Dickinson, Carnival Cruise Lines, Inc.
Michael Egan, Alamo Rent A Car
Edward P. Faberman, American Airlines, Inc.
Richard Fain, Royal Carribean Cruises, Ltd.
Gregory Fisher, Allied Tours
Charles Gillett, New York Convention & Visitors Bureau
Judson Green, Walt Disney Attractions
Darryl Hartley-Leonard, Hyatt Hotels Corporation
Noel Irwin-Hentschel, AmericanTours International
Robert E. Juliano, Hotel Employees and Restaurant Employees International Union
William Tiefel, Marriott Lodging
Jonathan M. Tisch, Loews Hotels

Chairman JOHNSON. I thank the panel for your comments.

Mr. Barclay, you heard the testimony of Mr. Murphy of the Department of Transportation. He claims that Wall Street analysts share his outlook that the airline industry is in an increasingly strong position, because over the last few years they have made structural changes in their cost base that positioned them well. How do you respond to his testimony?

Mr. BARCLAY. I think there is a tremendous difference between analysts that might be looking at market timing and brief periods in which an industry may do better than they have done before and long-term profitability. This is an industry that the economy has got to have running adequately and efficiently, and the long-term picture is simply very bleak. No one would put their money—

Chairman JOHNSON. To be more specific, certainly capacity has dropped severely through the restructuring. That does make higher loads possible. I personally have experienced the cancellation of a flight that was at roughly the same time as another flight just to reduce cost, at some inconvenience to passengers. Certainly, there are improving revenue streams and there has been a restructuring of the financial obligations of the industry.

Reducing capacity and restructuring the financial base and renegotiating contracts, all those kinds of things have long-term outyear affects. I think you do have some responsibility to meet more aggressively the claim that some on Wall Street see you now as well positioned for the future. This is one of the fundamental differences between the two sets of testimony, what is the state of health of the industry. I think it is significant that the industry has restructured its cost base so extensively that it now feels free to engage in what I think are rather outrageous competitive fare wars.

Mr. BARCLAY. Well, there is no doubt that the horizon of the industry looks better because of the numbers Mr. Murphy was talking about that are operating profits. This is an industry that has built 50 billion dollars' worth of debt over this recent period that you have got to factor in, and that is why they have no net profit. The fact that they may be coming out and earning profits in Wall Street cycles is not the correct long-term picture to look at for the industry, in our view.

Chairman JOHNSON. Thank you.

Would anyone else care to comment?

Ms. HALLETT. Madam Chairman, I think it is very important to respond in a little more detail. Certainly it is true that you can get different analysts to give different projections. However, many of the administration's numbers refer to operating profits. This figure does not include interest costs or debt service, and we use in the industry net profit, which includes all of those costs.

Treasury and Mr. Murphy say that the FAA, Federal Aviation Administration, reports the industry had an operating profit of $2.6 billion and a net profit of $1.2 billion for the fiscal year 1994. I want to point out that this is truly an accounting sleight of hand, because fiscal year 1994 includes the last quarter of calendar year 1993, and that is the quarter in which both Continental and TWA emerged from bankruptcy and, therefore, all of their debt service costs were written off.

In addition to that, our figures, the ATA figures that we have received from the Department of Transportation say that the calendar year loss for 1994 was $285 million for our industry. That certainly does not even relate to what we have heard this morning. I might point out that the first quarter of this year, 1995, we have had a loss of $88 million for new profit loss for this quarter. We are just simply not talking from the same sheet of music, and I think it is very important to keep in mind that you have to talk in terms of net profit, or it just does not compute.

Chairman JOHNSON. I think your point is very well taken. Thank you.

Mr. Levin.

Mr. LEVIN. Just to follow up, I very much agree with Mrs. Johnson's comments. I think it would be helpful if you would zero in on this issue, the overall standing of the airline industry and also the amount of taxes and other assessments, whatever one wants to call them, that are borne by the industry as compared with other modes of transportation.

There is a need to be fair here across the transportation industry, and I think it is true that the notion was that the exclusion of aviation would be temporary. I would add that unless there was reason to make it permanent, and that is the issue. I do not think we can resolve this today, but I think you and Treasury and everybody else in the next days should try to boil down your argument.

I just want to emphasize the reason for this is it is not going to be easy to find these monies. We are truly in a budget crunch and we have held this separately from the deficit, but in the end I think this all going to be rolled together. I do not mean in terms of one legislative package necessarily, but we are going to have to look at all sources of income and all expenditures, and I think we should get away from the kind of caricatures on the one hand that you really have an easy cushion at the moment. That clearly is not true, or, on the other hand, that the government is just being unreasonable as to knee-jerking it. I do not think that is true.

We have a problem and we all have to be part of the solution. You heard us ask the agencies to supply us with an assessment of the tax shares of the respective parts of this critical industry, and I think you should give us your analysis of it, including your assessment of the present and longer term economic condition. Clearly, the airline industry is critical and we here have to know what we are doing. I think the Chairwoman would very much welcome your boiling this down, and so would I.

Ms. HALLETT. Thank you, Mr. Levin.

I appreciate your comments and certainly we will be happy to submit additional written testimony in response.

I would like to just reiterate comments that were made this morning by not only the Members of the Subcommittee, but also in testimony, and to reiterate that in the case of the transportation industry entities involved, it is important to point out that we are indeed paying $6.5 billion in taxes, and that is a variety of taxes, some of which goes into the Aviation Trust. We have not in any way shirked our responsibility to more than pay our fair share.

As Mr. Collins indicated, if you put all of these costs together, we are currently paying 52.5 cents per gallon in tax. If we add the 4.3 cents, that would then take us up another 4.3 cents over the 52, and it is just a matter of how can you continue to keep people employed and airlines in the sky. For every 1-percent increase in ticket prices, there is an automatic 1-percent decrease in passenger traffic, and this has been true over the many years. We would welcome the opportunity to submit some more information to you.

[The following was subsequently received:]

Air Transport Association

Carol B. Hallett
President & Chief Executive Officer

May 30, 1995

The Honorable Sander Levin
2230 Rayburn HOB
Washington, D.C. 20515

Dear Congressman Levin:

I appreciate the opportunity to respond to the question you posed to me during the Oversight Subcommittee hearing on the jet fuel tax waiver extension.

Effectively, you asked that I provide you with information demonstrating the relative tax burdens of the airlines, as compared to other segments of the transportation industry, and how the airlines have already contributed to deficit reduction despite losing over $13 billion over the last five years.

With respect to the relative tax burdens of the airline industry compared to other sectors of the transportation industry, I think it is necessary to look into the taxes paid by airlines which differ from those other transportation sectors as well as any of those taxes which compensate the government for services. In effect, all transportation companies pay income taxes, and I am not aware of any substantial differing treatment within the transportation sector in the computation of income taxes.

In addition to income taxes, various transportation sector modes pay user fees and excise taxes. According to the Congressional Research Service, airline user fees and excise taxes exceed those paid by the trucking and railroad sectors by 115% and 661%, respectively. In exchange for those taxes and user fees, the airlines receive certain government provided services. According to the Congressional Budget Office's most recent cost allocation study, airlines pay 113% of the cost to the government for the services provided. Since the carriers are anticipated to pay to the government $6.5 billion in user fees and excise taxes in 1995, that 13% surplus amounts to $845 million which is effectively our contribution towards balancing the budget.

In addition to the $845 million in excess of services which the carriers will pay in user fees and excise taxes in 1995, there is an existing uncommitted balance in the aviation trust fund of $4,890,941.03. Since 95% of the fees paid into the trust fund are derived from the airlines, the airlines have also already paid $4,401,846.90 to offset the deficit (95% of the uncommitted balance).

Clearly, the airline industry pays substantially more than its fair share. I am not aware of any other industry which is paying so much, in comparison to others in the sector. Nor, for that matter, am I aware of any industry which pays so much more than the cost of service and receives such mediocre quality service from the government.

I hope that this answers your question. If there is any further information I can provide, please don't hesitate to contact me.

Sincerely,

Carol Hallett

Carol B. Hallett
President & CEO

Mr. LEVIN. Good. We need to finish this, so I think this is going to be one of the most difficult decisions and it is kind of easy for us to even sign a bill. It is harder to enact it in this situation.

Let me put it this way, and then I will finish. If the excise tax had been considered today instead of a few years ago, I think it would have been much harder for the airlines industry to have been excluded. It was because it was in a clearly precarious position.

I think the issue has somewhat changed. It is in a better position and now we need to argue out, I hope on a bipartisan basis—there is no reason for anything else—why you should continue to be excluded from it. In order to do that, we have to look at the entire transportation industry and projections as to the continued health or lack of it in this vital industry. You need to help us, and we will argue this out and try to come to a rational conclusion.

Thank you very much.

Chairman JOHNSON. Thank you, Mr. Levin.

Mr. Collins, briefly.

Mr. COLLINS. Thank you, Madam Chairman. I will talk fast. That is impossible. [Laughter.]

You know, you looked pretty good, Mr. Levin, standing there yesterday with that muscle in your hand. I liked the comparison you did with the cost of it here versus the cost in Japan. You made a very good point there. Your point on the tax on the airline industry was not nearly as impressive, for whatever that is worth.

Mr. LEVIN. If you will yield—

Mr. COLLINS. I do not have much time. I have got to be brief.

Mr. LEVIN. I am not at all unsympathetic to your position. I just think we need to be hardheaded on everything.

Mr. COLLINS. I've got you.

Ms. Hallett, it has been mentioned here this morning that the cost of fuel for the aviation industry is at a low point. However, I understand it is beginning to rise some. Some people suggest that, with it at a low point, this would be the appropriate time to impose this tax, because it would not be felt near as hard by the industry. What is your position? What do you think about that statement?

Ms. HALLETT. First of all, Mr. Collins, I think it is important to point out that just this year we have already seen an increase in the first few months of this year 1995. As an example, we are always about 2 months behind in terms of a lag to tell you exactly what the cost is today versus 2 months ago. In February, the cost was 56 cents per gallon. Since that time, we have had a continuing increase. In fact, crude was 10 percent just very recently, and now we know that there is going to be an increase of between 8 and 14 percent for the entire year.

We have just received, in fact, a very interesting report and it is one in which the front page says jet fuel prices to soar in 1995 adding $4 billion to costs. While that is worldwide, that impact directly on U.S. carriers is going to be extremely difficult for us to handle, without having to either continue layoffs or obviously make fewer purchases of aircraft, which relates, of course, to a decrease in the number of employees with those companies, and it is a snowball effect.

I guess the most important point I could make is that for each 1-cent-per-gallon increase in taxes or in the cost of fuel, there is an automatic $150 million increase in costs to our industry. If we have that kind of cost increase for every 1-cent-per-gallon increase, then obviously I think the handwriting is on the wall. It is going to be a very difficult year. There will not be profits and we will not be able to continue to employ as many employees as we have right now.

Mr. COLLINS. I think that is very well put, Ms. Hallett.

I want to refer to one other thing that you just mentioned, and that is a continued cancellation or further reduction or stall off in purchasing of equipment. When you look at your balance sheet, you look for depreciation, interest and profit to cover the cost of indebtedness. Is that not a fair statement?

Ms. HALLETT. Absolutely.

Mr. COLLINS. The way you get a depreciation schedule or cost figure down is not to purchase, and it will gradually go down over the time this equipment is depreciated out. That is also prolonging the purchase and requiring airlines to operate older equipment in order to stall off the purchase of equipment to lower that depreciation factor and to lower the indebtedness that you are having to meet.

Mr. Barclay mentioned that by the year 2000, the industry is going to have to purchase $80 billion in equipment. Was that the figure I heard you say?

Mr. BARCLAY. The industry estimates it at $15 billion a year between now and the end of the century.

Mr. COLLINS. This is going to have a reverse effect on what you are doing by increasing depreciation cost, lowering the profit structure and increasing the indebtedness.

Ms. HALLETT. That is absolutely correct.

Mr. COLLINS. It is a falsehood for the Department of Transportation—and I do not know why the Department of Transportation is even engaged in this conversation. It seems like it should be between the Ways and Means Committee, Congress, and the Department of the Treasury, not the Department of Transportation. They are just supposed to be the regulatory agency and not a taxing agency. Needless to say, they were here with their bells on to denounce this bill. They are really shooting themselves in the foot in the long run with anticipated revenues based on their approach to this tax and other taxation.

We appreciate your comments. Thank you, Madam Chairman.

Chairman JOHNSON. Thank you.

There are two brief questions to which I would like your response. Is there any difference in how this tax would hit long-haul versus short-haul carriers?

Ms. HALLETT. Of course, it is simply based on the amount of fuel that is purchased. Obviously, it is the amount of fuel that is purchased and the amount of flights that are flown.

[The following was subsequently received:]

Air Transport Association

Carol B. Hallett
President & Chief Executive Officer

May 10, 1995

The Honorable Nancy L. Johnson
Chairman
Committee on Ways and Means
Subcommittee on Oversight
343 Cannon House Office Building
Washington, D.C. 20515

Dear Madam Chairman:

I would like to thank you once again for the opportunity to testify before your Subcommittee on the commercial aviation jet fuel tax which is scheduled to be imposed on October 1, 1995.

I very much appreciate your interest in this issue and would like to offer a bit of clarification on a question which you asked regarding the potential competitive implications of the tax between short-haul and long-haul carriers.

To the extent that a greater amount of fuel is burned during an aircraft's ascent to cruising altitude then during cruise, carriers with a higher frequency of short-haul service would incur increased fuel burn costs due to the fact that a greater percentage of their total flight time would be utilized for achieving ascent to cruising altitude. Thus, carriers having a higher percentage of short-haul flights will be impacted more by the imposition of the aviation jet fuel tax than long-haul carriers.

I hope this clarifies my response during the hearing. If you have any further questions, please let me know.

Sincerely,

Carol

Chairman JOHNSON. That seems like a logical answer to me. Someone suggested to me that there was a difference, and I wanted to be sure whether there was a difference or there was not a difference. I hear you saying there is not a difference, and that is logical and I accept it.

Could you also comment on why, when you have overcapacity, you need to buy new airplanes?

Ms. HALLETT. Among other things, Madam Chairman, we are confronted with a number of different problems that we are responding to, by buying new planes that are quieter, for instance. Of course, there was legislation passed by Congress around 1990 that required all aircraft, by the year 2000, to meet stage 3 aircraft requirements to be quieter than the stage 2 aircraft that were primarily flown at the time. That would have been the old 727s, 737s, and a variety of other aircraft.

Today—and Mr. Barclay made reference to this—today, those new aircraft that are being purchased, of course, meet the stage 3 requirements. It i s obviously beneficial. As an example, the Boeing 777, which is a two-engine aircraft, it has a much greater capacity than does maybe its sister, the 757, and, therefore you can carry more people and have fewer airplanes landing in lieu thereof.

What we are looking at is the need to provide greater capacity, while at the same time meeting government regulations of not only stage 3, which is going to cost, as was mentioned, some $15 billion a year in upgrading of equipment to meet these requirements. It is almost endless. I am beginning to sound like a broken record, because one thing leads to another, all of which leads to increased costs for our industry, and that is one of the reasons why this increase in the fuel tax would be so detrimental to not only our short-term, but our long-term ability to meet the needs of the people.

Chairman JOHNSON. Thank you very much. I appreciate your comments. Thank you for your participation today.

The next panel will consist of Bernard Zahren, president of Zahren Alternative Power Corp., in Avon, Connecticut; and Francis Barkofske, vice president, external affairs, Zeigler Coal Holding Co., in Illinois.

It is a special pleasure to welcome Mr. Zahren to this hearing, as he is one of the examples of the ingenuity and vitality of my district.

STATEMENT OF BERNARD J. ZAHREN, PRESIDENT, ZAHREN ALTERNATIVE POWER CORP., AVON, CONNECTICUT; ON BEHALF OF SOLID WASTE ASSOCIATION OF NORTH AMERICA

Mr. ZAHREN. Does your vitality carry through lunch?

It is a pleasure to be here this morning. I am representing the Solid Waste Association of North America, which has approximately 5,400 members and basically represents many of the municipal landfill operators in this country.

We are here in support of an extension of the section 29 incentive for alternative fuels as it applies to landfill gas. Landfill gas is that gas which is generated in a landfill through the natural decomposition of the organic materials in the landfill.

We believe that the section 29 credit is a viable alternative to what we consider a current unfunded Federal mandate to the mu-

nicipal level of the landfill industry. The comments made earlier by Treasury indicated that the section 29 credit was a stimulus passed in 1980 to help other types of fuels become economically viable. Most of those other fuels were eliminated from the section 29 in 1992 by the Congress. Most of those fuels were things such as Devonian shale, tight sands, coalbed methane, and so forth, which had to be explored for in order to be used.

Landfill gas is a little different. Landfill gas comes out of every landfill, whether we go after it or not, and it is a very, detrimental greenhouse gas. According to the EPA, Environmental Protection Agency, the methane content of landfill gas is approximately 22 times more harmful to the atmosphere and the greenhouse gas problem than carbon dioxide. Therefore, reduction of the methane emissions from landfills is a very strong priority for the current Administration's commitment to reduce greenhouse gases to 1990 levels by 2000, as well as the world ecological and environmental concerns.

In line with that, the EPA is about to come out with a set of regulations this August covering the new source performance standards under the Clean Air Act. In the estimation of the Federal Government, the EPA, there will be approximately 10 percent of the 6,000 landfills in the United States that are currently either active or in the process of closing that will have to comply.

By complying, they will have to put in a collection system, collect the landfill gas and dispose of it. Our estimate of that cost for approximately 600 landfills, which is 10 percent of the total, would be somewhere in the neighborhood of $1.5 billion. Therefore, we feel that, first of all, these NSPS standards will amount to an unfunded Federal mandate which is being passed on to local communities, and the only alternative, particularly for a municipally owned landfill, will be to pass on that cost to every citizen of that municipality that has their trash picked up and disposed of at the landfill.

How do we turn this into a positive? Well, instead of spending $1.5 billion to simply dispose of this gas and flare it off to get rid of it, which is the primary objective under the NSPS standards, we propose that these 600 and, in fact, as many as 700 to 800 of these sources of landfill gas could economically be developed as an alternative fuel.

I disagree with Treasury on the statement that we no longer need an incentive for alternative fuels. I think we are far from out of the woods on the energy crisis, and economic utilization of approximately 600 more landfills would save on the order of 27 million barrels of imported oil per year, if we can use this fuel instead of flaring it.

I also disagree with Treasury on the revenue neutral side of this picture. If, instead of spending $1.5 billion in unfunded mandates, which are simply costs that will have to be borne by local residents, we turn around and employ private capital to build an energy recovery system, the typical rule of thumb is that private developers such as myself will spend approximately three times the total that it would cost just to collect the gas.

Instead of $1.5 billion to simply collect and flare off the gas, we are talking a new capital investment by private industry of approximately $4.5 billion to recover and use this gas. By doing so, as an entrepreneur, I would look at a project and I would not even entertain entering into a project unless I could make something in the neighborhood of 10 percent or better on my capital investment.

If you work that equation out, 10 percent of a $4.5 billion investment, roughly $450 million a year in additional profits—I do not know exactly what you folks in Congress plan to do with the income tax structure—currently at 35 percent, but that would be a Federal tax of approximately $157 million. Our estimate of the total section 29 tax credits available for these same 600 landfills—and I believe Treasury and the EPA, Evironmental Protection Agency, would agree with this—is in the neighborhood of $100 to $130 million a year. That is based on a year 2000 baseline, given another 4 years to develop these additional landfills.

Therefore, we believe that the implementation of incentives to encourage development of landfill gas as an alternative fuel not only strongly supports the administration's commitment to the reduction of greenhouse gases and to the global environment, but also provides an opportunity to increase taxes which will exceed by a considerable amount the amount of taxes given back in the form of this credit.

It is also not possible usually to use 100 percent of this credit. There are things such as alternative minimum tax, and so forth, which do not allow a developer such as myself to fully utilize the credit. I would argue that this is more than revenue positive, if we can effectively utilize this gas as an alternative fuel. I believe that the current sentiment in Congress, while you are concerned about a balanced budget and revenue neutral items, is to also be concerned about the unfunded Federal mandates, and this is a very large one when it comes down to State, municipal, and local government entities that operate these landfills and also the private operators of landfills.

Therefore, we strongly support, if not an indefinite extension of this credit, at least a 4-year extension of the in-service date, which is now due to expire for projects that do not have a binding contract by December 31, 1995, and are not in service by December 31, 1996. If Congress does not act this year to extend this incentive, we believe development on many of these potential projects will grind to a halt by December 31 of this year.

Likewise, we are seeking an extension of the sunset date on the back end of the credit for at least a comparable number of years, in other words, to the year 2011—or, if permanent, that would be lovely, also—but some extension longer than 2 years for the in-service date and the sunset date is our wish list here this morning.

We do not agree with Treasury. We would be happy to provide them with our revenue estimates from new taxes projects, and to support any other positions that we have taken relative to why they should support this from the Clinton administration's viewpoint of supporting greenhouse gas emission reductions.

The EPA is spending a lot of money on what they call the EPA Methane Outreach Program, which is intended to get States, electric utilities, municipalities and private developers to all cooperate in the use of landfill gas to reduce this methane emissions problem. Without this incentive, I think those of us on the private side who are being called on to provide the capital will have to largely walk away from this potential opportunity. Therefore, we would urge you to consider an extension of the section 29 Federal tax credits.

Thank you.

[The prepared statement follows:]

Testimony of

Bernard J. Zahren
President
Zahren Alternative Power Corporation
appearing on behalf of
The Solid Waste Association of North America

before

Subcommittee on Oversight of
the Committee on Ways and Means

May 9, 1995

Madam Chairwoman, members of the committee, my name is Bernard Zahren.

I am president of Zahren Alternative Power Corporation. We are in the business of tapping methane gas at landfills and using it to generate electricity. ZAPCO has 11 such projects operating currently, making it the fourth largest landfill gas company in the country if one measures by number of projects in operation, but we are much smaller if the measure is the kilowatt hours of electricity produced. Our projects tend to be fairly small in size.

I am here today on behalf of the Solid Waste Association of North America. SWANA is an association for landfill owners and operators, as well as for other solid waste management professionals. Most members of the association are local government officials charged with disposing of solid waste. There is also a separate trade association -- the National Solid Waste Management Association -- for private landfill owners. Both associations are supporting the effort that brings me before this committee today.

SWANA strongly encourages the committee to extend the section 29 tax credit.

The section 29 tax credit is a credit that encourages people to look for fuel in unusual places. The credit was originally enacted in 1980, and it has been extended three times since then. The amount is adjusted each year for inflation. It was $5.76 for the equivalent of each barrel of oil that a taxpayer produces in alternative fuels in 1994. The figure for 1995 production won't be announced by the Internal Revenue Service until April next year.

The credit used to apply to a large number of alternative fuels, including gas from Devonian shale, tight sand formations, coal seams, geopressured brine and biomass, oil from shale or tar sands, and synthetic fuels from coal. However, the list was cut back to just two fuels the last time Congress extended the credit in 1992. The two that still qualify are "gas from biomass" and "synthetic fuels produced from coal." An example of "gas from biomass" is methane produced by decomposing garbage at landfills.

The idea was to get people to look in places for fuel that they would not look if left on their own. Thus, the credit phases out automatically if oil prices return to levels that make it economic to produce these fuels without the subsidy provided by the tax credit. The credit was not available for the first two years after it was enacted because oil prices were in this range.

There is a deadline for placing projects in service to qualify for the credit. Projects that produce the remaining two fuels still qualifying for tax credits must be in service by December next year.

We are asking Congress to extend this deadline for another four years through December 2000 for the two fuels that still qualify.

Projects that are in service by this deadline qualify for tax credits currently on the fuel they produce through 2007. This is the "expiration date" for the credit, as opposed to the deadline for placing projects in service. We are asking that this expiration date also be pushed back by four years.

It is important that Congress act this year to extend the credit before work grinds to a halt on projects that are under development as developers conclude there is too great a risk these projects won't be finished in time to place in service by December next year. Synthetic coal fuel projects have long lead times. Landfill gas projects have shorter lead times. Work will stop on many new projects well before the deadline at the end of next year unless Congress has taken steps to extend the credit. There is no sense in continuing to pour money into a project for which the credit is a necessary inducement if the project can't get into operation in time to qualify.

Why should Congress extend the credit?

Before I answer this question, please understand that what drove Congress to enact the section 29 credit in the first place in 1980 is not what has led it to extend it in the 1990's. The credit was originally part of a strategy for making the United States less dependent on imported oil. The Arab oil embargo was still fresh in people's minds. The country had just gone through not only painful energy

shortages, long lines at gasoline stations, inflation and high interest rates driven by spiralling prices for oil, but also a deep recession due to the high interest rates. Congress was determined that the country not be held hostage again to one side's interests in the Middle East conflict. It enacted a series of measures aimed at encouraging business to use energy more efficiently and at inducing business to rely more on renewable fuels -- like sunlight, wind, geothermal fluid and waste -- and to tap previously untapped resources for fuel. The section 29 tax credit was part of this strategy.

By 1992, the sense of urgency was gone. The logic for continuing the credit for many of the fuels covered was gone. Thus, Congress kept it only for two fuels -- basically landfill gas and synthetic fuels from coal. In the case of landfill gas, there is an unfunded mandates problem and there are important environmental reasons for continuing the credit. In the case of synthetic fuels from coal, the United States has tremendous coal reserves, but coal can be a dirty fuel and there was a desire to keep efforts underway to develop coal-based fuels as an alternative to burning straight coal.

SWANA's interest is landfill gas. Decomposing garbage produces methane. Methane is a potential health and safety hazard, as it will find an outlet from the landfill. The gas has two possible outlets. It can migrate underground to adjoining properties, where it kills or stunts vegetation by displacing oxygen from the ground. Alternatively, it can escape into the atmosphere. Contaminants in the gas contribute to air pollution and mix with sunlight to create smog. During the 1980's, there were more than two dozen life-threatening explosions and at least three deaths due to landfill gas accumulation in nearby structures.

Landfill owners take steps to control the gas either by installing "passive" systems, like trenches, barriers and vents to prevent gas from migrating underground and to give it an outlet into the atmosphere, or by installing "active" systems where the gas is pumped to the surface and either flared, vented, or collected for use as fuel.

Use as fuel is still infrequent. There are approximately 6,000 active and recently-closed landfills in the United States. At the end of 1990, gas was being collected for fuel at just 97. In 1995, the figure is still only 143.

Last year, the federal Environmental Protection Agency created a special Landfill Methane Outreach Program in an effort to encourage more collection of landfill gas for use as fuel. Methane is a greenhouse gas that contributes to global warming. It is the second largest contributor to global warming after carbon dioxide, and landfills are the single largest identified source of methane emissions,

accounting for more than a third of total methane released by the United States.

Greenhouse gases are expected to increase by 14.5% during the 1990's. The Clinton administration committed in April 1993 to hold greenhouse gas emissions to 1990 levels. The Landfill Methane Outreach Program is an effort to avert this increase. EPA is preparing a report to Congress on barriers to landfill gas projects, it has set up a hotline to cut through red tape, and it is in the process of signing cooperative agreements with states and utilities to encourage more landfill gas utilization.

Congress should extend the section 29 tax credit because there is unfinished business at the nation's landfills. Word about the credit was slow to get out. Most landfill owners have only recently become aware of it, and having become aware, the pace of landfill gas development is increasing noticeably. There was almost a 50% increase in landfill gas projects in the last five years. The credit needs more time to reach its potential.

EPA estimates that approximately 750 of the estimated 6,000 active and recently-closed landfills in the United States are candidates for landfill gas production. It won't happen without the credit.

Congress should also extend the credit because it is a reasonably low-cost response to the problem of unfunded mandates. From the standpoint of SWANA, most of whose members are local government officials, the federal government has imposed standards on landfill operations, but provided no money to implement them. The Environmental Protection Agency proposed "new source performance standards" for landfills in May 1991, and it has revised them twice since then. As currently proposed, the new standards would require any landfill with a design capacity or solid waste in place of at least 2.5 million metric tons, and whose nonmethane organic compound emissions are expected to exceed 50 metric tons a year, to install a control system.

The credit is an inducement to the private sector to do the municipality's work. We are opposed to dropping the credit but leaving the federal mandates in place.

The new source performance standards will not take effect until the federal government reissues them in final form. That is currently expected to occur in August, but they have been delayed a number of times, so the publication date may be delayed further. In the meantime, many landfill owners are unwilling to commit to landfill gas projects because they want to see what the final rules require. They are quickly backing up against a wall, since section 29 requires not only that landfill gas projects be in service by December next year to qualify for tax credits, but also that there be a binding contract for the project by the end of

this year. There isn't much time left for binding contracts, and if the rules are delayed again, there will no time at all.

Congress should also extend the credit because this is something tangible the United States can point to that it is doing to reduce greenhouse gas emissions that contribute to global warming. Let me read from an editorial in The Economist magazine from April 8, 1995.

> "Hyprocrisy is nothing new in international politics. But when the topic is global warming, the ability of governments to say one thing and do another is, let's say, breathtaking. As the Berlin climate-change summiteers waffled on this week, official delegations held countless press conferences proclaiming how worried their governments were that the accumulation of greenhouse gases could lead to catastrophe. At countless closed meetings, each country then refused to do anything much about it."

Rich countries committed in 1993 to reduce greenhouse gas emissions to 1990 levels by the year 2000. The Environmental Protection Agency has concluded it is impossible for the United States to meet this commitment without taking aggressive steps to encourage more landfill gas collection at landfills.

Cindy Jacobs, manager of the Landfill Methane Outreach Program at EPA, gave some interesting statistics in a talk last year. The Clinton administration is counting on 43% of the reductions in greenhouse gas to come from the efforts it is making through the Landfill Methane Outreach Program and its other "green programs." Methane accounts for 18% of total greenhouse gas emissions -- the second largest contributor to global warming after carbon dioxide. However, methane is about 20 times more effective than carbon dioxide in trapping heat in the atmosphere, so its contribution to global warming is far out of proportion to its percentage in the mix of total gases. Landfills are the largest identified source of methane in the United States, and the United States accounts for 35% of total landfill methane emissions worldwide.

Many air pollution officials -- not just at EPA but also at the state and local level -- would like to see the tax credit extended.

Finally, let me speak briefly to the economics of landfill gas projects and why most such projects won't be built without the tax credit. Landfill gas is more expensive to collect and use as fuel than to flare. Once collected, it is too impure and has too low an energy content to be put in pipelines and mixed with natural gas, so there is a limited market for it. The market is basically potential industrial consumers within a one- or two-mile radius of the landfill.

There often aren't any such people. Consequently, at most projects, the developer of the project will install electric generating equipment -- which adds to the cost -- to use the gas for generating electricity.

The electricity is sold to the local utility. Thus, in most projects, the source of revenue to cover the costs of the project is revenue from electricity sales. The developer needs about 5¢ to 6¢ per kilowatt hour from the utility in most cases to make the project economic. Utility "avoided costs" -- the amount that the utility is prepared to pay a wholesale supplier for electricity -- are in the 3 to 4¢ range in areas of the country where additional capacity is needed. They are roughly 2 to 2 1/2¢ a kilowatt hour in other areas. The developer might get a slightly higher average price from the utility under a long-term contract because of the way the escalators and capacity charges are calculated under such contracts. The tax credit is worth about 1¢ per kilowatt hour. The bottom line is that it is the difference currently between whether or not a project is economic.

In conclusion, Congress should extend the section 29 tax credit for the two fuels that qualify currently.

It should do this because there is still unfinished business at the nation's landfills, the credit is an inexpensive way of getting the private sector to do the municipalities' work in carrying out unfunded mandates involving landfills, and the credit is important to carrying through on the commitment the United States has made to reduce greenhouse gas emissions.

Chairman JOHNSON. Thank you.
Mr. Barkofske.

STATEMENT OF FRANCIS L. BARKOFSKE, VICE PRESIDENT, EXTERNAL AFFAIRS, ZEIGLER COAL HOLDING CO., FAIRVIEW HEIGHTS, ILLINOIS

Mr. BARKOFSKE. Thank you, Madam Chairman.

My name is Frank Barkofske. I am vice president of external affairs of Zeigler Coal Holding Co., an Illinois-based company, right outside of St. Louis, Missouri.

I have filed written testimony with the Committee in support of extending the deadline for synthetic fuels under section 29 for nonconventional fuels, the time period for which the facility should be put in production.

In the time alloted to me this afternoon, I would like to briefly describe two things, Madam Chairman. One is a project we have called the ENCOAL project, which has been qualified for the section 29 treatment, and the second briefly describes the importance of the project extending the deadlines.

My colleague to my left has already gone into section 29(c) and the time constraints. In order to save time, I would simply say we are under those same constraints as his biomass project is.

Our ENCOAL project is located adjacent to a coal mine in Wyoming. This is a project which is funded, 50 percent by the Department of Energy, and 50 percent by my company. It involves a total expenditure of approximately $90 million, of which DOE, the Department of Energy, is funding $45 million and we are funding $45 million.

It involves a new and advanced technology of converting low-rank coals; by low-rank coals, I mean those that have a great deal of moisture, a low heating value, and a relatively low sulfur coal, into a product of a higher heating value, and removing the moisture from it as well as reducing the sulfur in the coal.

Through a treatment process, the coal is actually chemically converted from one product, meaning the Powder River Basin coal—and by the way, this can also be used for lignite coal in Texas as well as in North Dakota, and we are in the testing stages of developing the same product for some of the Midwestern, higher sulfur coal.

Through a chemical process, the coal is dried, and then heated to a high temperature, and a liquid is then created, and is turned into a gas which is then cooled down, and results in a liquid fuel, very similar to a number six fuel oil.

The second component, which is the coal component, results in a coal product in where the BTU, the heating value, is raised from approximately 8,300 to over 11,000 BTUs.

The sulfur is reduced even further, from approximately 1.2 pounds of sulfur per billion BTUs, to 0.8 percent of sulfur per million BTUs. Approximately a 25-percent reduction in the sulfur of this already low-sulfur coal.

This has an application both to Wyoming coal, but it also has a benefit to other parts of the country. Under the Clean Air Act, as the Chairman is well aware of, the phase II compliance, which is

the year 2000, requires that coals be further reduced in their sulfur emissions.

This product, which is created by the ENCOAL process, is referred to in some places as supercompliance coal. It is going to overcomply, which means that other coals can then be blended in it, as well as being used to earn emission credits.

This is not simply a regional process. We are doing it in Wyoming because we have a coal mine there, and it is adjacent to it, and we have a fuel that is able to be used for the process. As I said, there are other projects around the country.

For instance, we are currently in discussions with ALCOA for a project in Rockdale, Texas, next to their lignite mine, in which they will use this for their power purposes in their aluminum plant.

We feel that we are simply on the cutting edge of this, and that it would be a mistake to cut off a project. We cannot market a commercial size project of this time with its status of section 29(c). With the expiring tax credit, we are finding that investors will not put in the $200 to $400 million required for a commercial size plant.

We think this would be a mistake, to stop a program that should be commercially adaptable, that is, environmentally doing what it should do, and as well as the section 29 purpose, to have independent fuels being developed so that our energy needs are met by our own coals, and our own energy fuels.

The last point I would like to make, Madam Chairman, is the AMT, alternative minimum tax. Alternative minimum taxpayers cannot presently take advantage of section 29 credits.

Zeigler happens to be an alternative minimum taxpayer. We are finding that many of the people who would invest in the commercial program are also not able to take advantage of it.

I commend this Committee for having recommended that the AMT tax be eliminated as of January 1, 2000. However, because of the time constraints, we do not believe that is going to help our commercial project, because already, people are beginning to wonder whether or not this credit is going to be available.

If they cannot take it now, the year 2000 is going to be too late. We would ask also, that the Committee consider eliminating that as a preference for this type of a project.

[The prepared statement follows:]

TESTIMONY OF
FRANCIS L. BARKOFSKE, VICE PRESIDENT - EXTERNAL AFFAIRS
ZEIGLER COAL HOLDING COMPANY
BEFORE THE SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
ON THE
PRODUCTION TAX CREDIT FOR NONCONVENTIONAL FUELS

MAY 9, 1995

Madame Chairman and members of the subcommittee, I am pleased to appear before you today to discuss the value of the production tax credit for nonconventional fuels. My name is Frank Barkofske, Vice President for External Affairs for Zeigler Coal Holding Company. Zeigler Coal is an Illinois-based company with its headquarters in Fairview Heights, just east of St. Louis, Missouri.

I am here today to testify in support of extending the placed in service date under Code section 29(g)(1) from January 1, 1997 to January 1, 2000, and eliminating the binding contract deadline of January 1, 1996 for synthetic fuels produced from coal. These dates were set in the 1992 Energy Act.

Section 29 tax credits are available as incentives to clean coal facilities for coal-derived clean fuels that are sold before January 1, 2008. However, under current law, these credits are available only if the qualified fuels are produced in facilities placed in service before January 1, 1997 and if there is a binding contract for such a facility entered into before January 1, 1996.

THE ENCOAL PROJECT

ENCOAL Corporation, which is owned by a subsidiary of Zeigler Coal Holding Company, has built and is now operating a first-of-its-kind coal upgrading plant near Gillette, Wyoming. Using a new and advanced technology called Liquids-from-Coal (LFC), the plant is capable of converting up to 1,000 tons per day of low-rank Powder River Basin coals into low-sulfur, high-quality solid and liquid fuels.

Low-rank coals abound in the Powder River Basin and throughout much of the West. While low in sulfur, these coals tend to have high moisture levels and lower heating values than most eastern U.S. coals. The LFC process subjects the coal to significant changes in chemical composition and removes moisture to produce higher quality fuels.

In the LFC process, coal is dried and heated so that part of the coal is converted to a gas. The gaseous vapors are cleaned and cooled, then condensed to form a liquid that can be used as an industrial fuel. This liquid also has potential as a feedstock for transportation and the production of chemicals. A low-sulfur, clean-burning solid fuel is also produced which has a higher heating value than the raw coal and has up to 25 percent of the sulfur content removed. We have tested the LFC process on other coals and have found it equally effective in raising the heating value and removing sulfur content.

The technological breakthrough represented by the LFC process will make the synthetic coal particularly attractive for power-generating companies that must reduce sulfur dioxide emissions to comply with the 1990 Clean Air Act Amendments. Currently, the technology has been successfully tested on Alaskan Lignite, Powder River Basin Subbituminous, Dakota Lignite, and Texas Lignite. Current possibilities for commercial facilities related to the ENCOAL project include Triton's Buckskin Mine near Gillette, Wyoming and Zeigler's properties near Rockdale, Texas.

In the case of the ENCOAL project, royalty revenue for the U.S. government could be as high as $45 million.

The ENCOAL project is one of the most successful projects in the Department of Energy's Clean Coal Technology program. The Department of Energy and ENCOAL entered into a cooperative agreement in September of 1990. DOE and ENCOAL are equally sharing the project's cost of $90 million. As part of that agreement, the DOE stands to receive royalties from the licensing of the ENCOAL process equal to an amount up to the $45 million federal expenditure. DOE authorized a final installment on the ENCOAL project in September 1994.

SECTION 29--AN INCENTIVE FOR "NON-CONVENTIONAL" FUELS DEVELOPMENT

In 1980, following the second major oil shock in seven years, the Congress enacted section 29 tax credits. Section 29 was intended to provide incentives for the production of alternative (or non-conventional fuels). Section 29(c)(1)(C) provides incentives to promote the construction of facilities that produce new, synthetic fuels from coal. Billions of dollars have been invested in these projects by private sector companies and the federal government over the past decade to develop and demonstrate new coal based alternative fuel technologies.

LARGE CAPITAL REQUIREMENT DELAYS MAKE DEADLINES UNREALISTIC

Zeigler Coal and other companies that have invested millions of dollars in promising new clean coal technologies will not be able to meet these deadlines. In some cases, these dates are unrealistic due to extraordinary up-front capital investment and expenditure requirements. Uncertain returns require extensive market analysis by potential investors. In addition, investors are unlikely to invest in "risky" clean coal technology projects that are not projected to deliver consistently above average returns on the investment. It is important that returns on investment match the risk involved in new technologies. Building a commercial sized clean coal plant could require an investment of up to $400 to $500 million. This level of investment will only happen if risks are minimized. The section 29 credit is intended to get new clean coal technologies off the ground by minimizing such risks.

CLEAN COAL COMMERCIALIZATION REQUIRES LONG LEAD TIMES

The long lead times needed for plant planning and construction make these deadlines unrealistic. It is often difficult to quickly meet all federal, state, and local permitting and regulatory requirements in order to build a major industrial plant. It is especially difficult for the coal industry to quickly meet permitting and regulatory requirements because of environmental, worker safety, and other related concerns. Construction of clean coal plants can often be delayed due to logistical and technical obstacles. Many coal mines, which are likely locations for clean coal plant construction, are located in remote areas with limited access to building materials. In short, materials delayed at any point during the transportation process can hold up construction. Assembling and fine-tuning new clean coal technologies can also lead to delays.

RECENT IRS ACTION INHIBITS USE OF SECTION 29

Stability in the tax system is also important. For example, one obstacle to meeting the current deadlines for some companies can be directly attributed to a recent IRS action. The Internal Revenue Service raised uncertainty for Zeigler Coal and other companies due to a recent series of private letter rulings withdrawing eligibility for section 29 credits from several coal companies. As Kennecott has outlined in it's testimony, 100 people lost their jobs due to the uncertainty caused by a delay

related to the IRS withdrawal of private letter action. Potential investors in Zeigler Coal's clean coal technology project were also given cause for concern due to this action.

The IRS issued a private letter ruling (PL8836071) on June 17, 1988 to Shell Mining Company (which owned the ENCOAL project at that time) in which they ruled that the synthetic fuels derived from coal are qualified fuels under section 29(c)(1)(C) of the Internal Revenue Code. On February 14, 1995, the IRS issued a withdrawal of the private letter ruling, effectively disqualifying the synthetic fuels produced from coal at Zeigler Coal's ENCOAL plant. Zeigler Coal immediately requested that the service reconsider its withdrawal of the 1988 ruling under which ENCOAL had already made commitments and expenditures of nearly $45 million. I am pleased to report that last week we received notice that the IRS had reconsidered its withdrawal and has now reinstated its 1988 ruling. It is my understanding that other companies also had their private letter ruling withdrawn and, after appealing the IRS action, had the withdrawal rescinded.

Despite these obstacles to advancing new clean coal technology projects, Zeigler Coal and other companies would like to move beyond the demonstration phase to the commercial phase.

CLEAN COAL TECHNOLOGY HELPS MEET PHASE II OF THE CLEAN AIR ACT

Advancing clean coal technology from the demonstration phase to the commercialization phase will help meet the mandated goals for Phase II of the Clean Air Act. Coal is the primary and most abundant energy source in the United States. Over fifty-seven percent of electricity is produced from coal. In 1990, Congress amended the Clean Air Act to require reduced sulfur emissions and other pollutants from coal-burning power plants. Phase I facilities (110 power plants) began their reductions on January 1, 1995 and all plants must be in compliance by the Phase II date, January 1, 2000. Utilities and industry were expected by Congress to make widespread use of alternative clean fuels produced from coal to help achieve these reductions. Clean coal projects can help the power generation industry meet Phase II of the Clean Air Act.

THE ALTERNATIVE MINIMUM TAX IS A BARRIER TO ADVANCING "NONCONVENTIONAL FUELS" TO COMMERCIALIZATION

I would like to commend the Committee on Ways and Means for reporting a bill to the House floor to repeal the alternative minimum tax (AMT). Companies interested in acquiring a license to use the ENCOAL coal synthesizing process in their operations are often AMT payers. Unfortunately for Zeigler Coal, currently an AMT payer, the repeal date does not come soon enough to spur the commercialization of the ENCOAL project. In short, we would like to have the section 29 credit available as an offset against AMT liability prior to the year 2000. Without this relief, Zeigler is unlikely to build another plant to synthesize coal into cleaner liquid and solid fuels.

The AMT undermines U.S. "non-conventional" fuels tax and clean coal appropriations policy. The government has provided Section 29 tax credits to encourage the development of alternative fuel sources. However, companies engaging in a "good faith" clean coal technology partnership with the government are discouraged from advancing the most successful projects to commercial use due to the inability of AMT paying companies to offset the credit against AMT liability. This contradiction in policies does not make sense. If the advancement of clean coal technology is good energy and environment policy for regular taxpayers to undertake, it is good policy for AMT payers to undertake as well. The intent of the AMT is to ensure all companies pay some tax. The AMT is not intended to undermine U.S. energy and environment policy. We would like you to consider further AMT relief as of January 1, 1996 for new clean coal technologies, as a supplement to the extension.

CONCLUSION

Madame Chairman and members of the subcommittee, I want to thank you for the opportunity to testify before you today. Zeigler Coal strongly supports the extension of the "placed in service" requirement for synthetic fuels derived from coal from January 1, 1997 to January 1, 2000 and repeal of the binding contract clause. I hope that my testimony has provided you with the information you need to offer this recommendation as part of a second tax bill this year. Thank you.

Chairman JOHNSON. I thank you for your testimony. It is interesting that in both the technologies that you talk about, one of the pressures that you are responding to are changes in Federal law to achieve environmental goals, that at the time we passed the law setting those goals, we did not have the technology to achieve them.

Around here, we call it technology pressing law, and you are the technology we press.

Mr. BARKOFSKE. And we can now put it into effect.

Chairman JOHNSON. It is interesting that there is a response, and with some very favorable spinoff. However, in your cases, and in the cases of others who have talked to us about this law, who are not currently covered by it, the issue really is not so much development of technology. It is really operating subsidies until you get big enough to be able to capitalize your own development.

That is a little different issue than keeping these credits in place throughout the life of the program that is needed to achieve compliance by the year 2000.

I would ask you to get back to us about what kinds of things we might look at to more directly tailor this support system, to, in a sense, the shorter term issue of creating the volume of demand that would allow you to commercialize the technology in a way that it is self-supporting.

It does not seem to me that that is a 5-year project. It seems to me that that is less than 5 years. And I am not saying that so much from my knowledge of landfill issues, or clean coal technology, as I am from some other approaches that are also interested in this.

That basically, they have a product, they have a technology that meets a very real need, but if they could lower their production costs for the product, they would be a big market competitor.

They cannot lower their production costs until they increase their volume. They cannot increase their volume until they lower their production costs. There is a place for government to help new technologies to get, in a sense, commercialized and viable, by subsidizing them through that period of volume growth.

At some point with the number of landfills that you mentioned, Bernie, and the timeframe within which States and local governments need to comply, I mean, there is clearly a demand.

What is that really essential need, that allows this demand to be met in a way that lowers the cost for local and State government because you have a viable product out there?

Mr. ZAHREN. We have a viable product from a technology standpoint, if you are going to make electric power, which is the predominant use of landfill gas today. Of 150 or so projects that are in production, using landfill gas, over 100 of them make electric power. The rest simply send the gas to a nearby boiler unit of some sort.

If we are to develop the 600 additional landfills, it is my belief that we will not be able to make electric power at most of those sites, and that is due to another Federal initiative which is currently underway, which I believe in, and that is the deregulation of the electric utility industry.

The FERC, Federal Energy Regulatory Commission, has just come out with a proposed major new set of regulations that will unbundle the transmission and the generation of electric power. Because of all of this, none of the utilities are anxious to buy our power today at rates that will allow us to be competitive.

Most of my 11 projects make power for 5- to 6-cents-per-kilowatt hour. Go back to our home State and ask Northeast Utilities what they will pay for power today. It is 2.6 cents.

I cannot make additional projects work at that kind of power rate. We do not have a need for a subsidy to make up the difference in electric rates, but a need for, indeed, R&D, research and development, to find new markets for the gas. I believe those markets will be in vehicle fuel, which is developing quickly, and results from another Federal set of mandates for the nonattainment air pollution areas, to convert fleets of over 20 vehicles to operate on an alternative fuel.

That can be done in the form of liquified natural gas, compressed natural gas, methanol, and potentially other products, all of which can be manufactured from the methane contained in a landfill.

I can not do that in the next 24 months, because the technology is largely unproven and undemonstrated. I can make electric power tomorrow, but I'm not building any more projects because I can't get the electric power contract.

I think the utilization of the gas is very dependent on new and different technologies for the use of the gas, which will take more than a year or two to implement.

Chairman JOHNSON. Thank you. That is very interesting. You see your market changing, and so actually this is the development credit for you?

Mr. ZAHREN. It is development; yes.

Chairman JOHNSON. Well, if you think about timeframes, that would be helpful to us.

Do you care to make a comment, Mr. Barkofske?

Mr. BARKOFSKE. Yes, I would, Madam Chairman.

Let me just say that our demonstration plan, which is the plant I described out in Wyoming, has proved itself.

The DOE considers it one of the flagships in their clean coal technology programs, and I think there is going to be filed in the record a copy of a letter from the DOE on the project.

We have a good project which is meeting the needs of clean coal technology, environmentally superior, and is domestic energy. The trouble we are having is to interest someone to build that first commercial plant, which is a $200 to $400 million expenditure.

We are finding that they are telling us, and we believe it because we would do the same thing—that without this section 29 tax credit, at least to the year 2008, as provided for in current law, the risk factor involved on this, the need to invest the capital is such that they have better needs for their money.

We believe that if we get one commercial plant going during this time period, then the economics of that process will carry itself.

So we are not asking—while my colleague indicated it would be nice to continue these credits forever, we are not seeking that from this Committee.

We are simply saying that we cannot meet the January 1, 1996, deadline for a binding contract, and the January 1, 1997 deadline for a plant in service for this size of an operation.

We are not asking for any additional help on our demonstration plant. We are simply saying let's go into the year 2000, which coincides with phase II of the Clean Air Act, to allow us to market this concept, and to get someone such as, hopefully, ALCOA, to put in a project like this, and definitely prove that on a commercial size it will make sense.

Chairman JOHNSON. Are you saying, then, that really, all you need is the time to get one project up and running under section 29?

Mr. BARKOFSKE. Yes, ma'am. I think that conceptually, since you are looking at 2 to 3 years for finishing a project, that is what we are looking at in the time phase of January 1, 2000. If it cannot carry its load after that, then I agree with some comments that have been made, that, it ought to fall by the wayside.

We do not think it will. We think this is a good project, and we have just run out of time to market it on a commercial size.

The DOE under our agreement, has a chance, once we license one of these plants, to begin to recoup the $45 million that they have expended for the project. Whether they will get it all back or not, I do not know, but there will be a revenue-raising aspect in it.

It is one of these things, that you see the light out there, it is not too far out there, and you are reaching for it, and we just cannot make it, Madam Chairman, and we are asking for Congress' help to extend the deadline.

Chairman JOHNSON. Once you build this plant, then you have an obligation to repay some of the DOE moneys?

Mr. BARKOFSKE. Our obligation is based on any licensing fee we have for this project, they get a certain percentage of it, up to the amount they have expended. Yes, ma'am.

Chairman JOHNSON. Perhaps you could give us a little more detail on that agreement, so that we could see that mechanism more clearly.

[The following was subsequently received:]

Department of Energy
Washington, DC 20585

The Honorable J. Dennis Hastert
U. S. House of Representatives
Washington, D.C. 20515-1314

Dear Congressman Hastert:

This is in response to your letter of March 30, 1995, requesting an evaluation of the success and commercial viability of the ENCOAL Clean Coal project as well as whether the Federal Government will be repaid as a result of the recoupment provisions in the associated Cooperative Agreement.

The ENCOAL plant began operations (production of coal fuels) in May 1994. It is producing both a low-sulfur, coal-derived liquid fuel (CDL) similar in quality to a low-sulfur No. 6 fuel oil and the second is a solid, process derived high-Btu fuel (PDF).

Process operating variations are still under study to identify ways to improve the stability of the solid product. ENCOAL has demonstrated that the PDF can be transported in rail cars by shipping it to Muscatine Power & Water in eastern Iowa under a thin blanket of Powder River Basin coal. This technique produced a blend which was successfully test burned in December 1994. A report on all commercial testing of both liquid and solid products will be issued in the near future.

The technical achievements to date support the participants in their belief that the project has a high success potential. The number of major utilities requesting ENCOAL's products for blending purposes, has increased markedly since the plant started operation.

The participant projects that PDF can be sold at a market price (on an equivalent energy content basis) normally expected for low sulfur eastern bituminous coal without any government support and/or credits. CDL product prices are dependent on the volatility of the oil sector, and PDF prices to the energy sector. The commercial economics remain to be confirmed, however, and the data from the extended operating period are factors essential to that assessment.

If brought to commercial viability, the ENCOAL project will help serve U.S. energy interests and enhance opportunities for economic growth. In addition, the project will help ensure a sustainable environment through the development of new technology. In short, the ENCOAL project has earned my strong support and is an excellent example of a successful public/private sector partnership.

You also asked about the recoupment of the federal government's investment of $45 million. If the ENCOAL project is not brought to commercial viability, the government will not recoup it's investment. However, if the project were to be licensed commercially, the federal government could receive royalties up to the $45 million public investment.

The Comprehensive Report to Congress, issued in June 1990, is enclosed. Meanwhile if we can be of assistance in any other way, please contact us.

Very truly yours,

Patricia Fry Godley
Assistant Secretary
for Fossil Energy

Enclosure

REPAYMENT AGREEMENT

ARTICLE I — GENERAL OBJECTIVE

The purpose of this agreement is to set forth the terms and conditions under which ENCOAL Corporation (defined herein as the Participant) shall repay to the United States Department of Energy (DOE) an amount up to (i.e., not to exceed) the Government's share of total project costs paid under Cooperative Agreement No. DE-FC21-90MC27339.

ARTICLE II — DEFINITIONS

"Contracting Officer" means the DOE official authorized to execute awards, financial agreements, and amendments thereto on behalf of DOE and who is responsible for administering this Repayment Agreement.

"Cooperative Agreement" means the financial assistance award made by the United States Department of Energy (DOE) to the Participant, Instrument Number DE-FC21-90MC27339 on _____ 1990 and subsequent amendments.

"DOE" means the United States Department of Energy and any successor department or agency.

"DOE share" means the portion of the total project costs paid by DOE under the Cooperative Agreement.

"Government" means the government of the United States, including DOE.

"Licensing Contractor" means the TEK-KOL partner designated under the TEK-KOL Partnership Agreement to undertake the primary licensing and development activities relating to the commercialization of the Demonstrated Technology.

"Participant" means ENCOAL Corporation and its successors and assigns.

"Project" means the set of activities described in Article XI (Allowable Pre-Award Costs) and in Attachment A, Statement of Work, of the Cooperative Agreement.

"SMC" means Shell Mining Company.

"TEK-KOL" means the California General Partnership between SGI International, a Utah corporation with offices in La Jolla, California, and SMC, the developers of the LFC Technology. TEK-KOL has entered into an Agreement of even date herewith to develop and commercialize the Demonstrated Technology on behalf of the Participant.

"Total project costs" means the total amount of allowable direct and indirect costs incurred by the Participant and paid, in part, by DOE under the Cooperative Agreement.

"United States" means any of the several States of the United States, the District of Columbia, the Commonwealth of Puerto Rico, and any territory or possession of the United States.

ARTICLE III — TERM OF THIS REPAYMENT AGREEMENT

This Repayment Agreement shall become effective on the date specified in the Cooperative Agreement as the end of Phase III (Operation) or as may be extended by any subsequent contract modifications, except that if the Participant unilaterally withdraws or terminates its participation under the Cooperative Agreement, this Repayment Agreement shall become effective on the date the Cooperative Agreement is terminated. This Repayment Agreement shall expire 20 years from its effective date or on the date the entire DOE share has been repaid, whichever occurs first. This Repayment Agreement may be terminated upon a determination by the Secretary of Energy or designee that repayment places the Participant at a competitive disadvantage in domestic or international markets.

ARTICLE IV — DEMONSTRATION TECHNOLOGY

(A) Demonstration Technology

For purposes of this Repayment Agreement, the "Demonstration Technology" shall consist of the mild gasification process based on the Liquids-from-Coal (LFC) Technology developed by TEK-KOL. The process involves deep drying and heating coal under carefully controlled conditions causing chemical changes in the coal. The chemical changes result from decomposition or pyrolysis of the coal producing gases and solid residue. The solids are further processed and stabilized producing a new fuel form, Process Derived Fuel (PDF). The gases are cooled and partially condensed, forming a second new fuel form called Coal Derived Liquid (CDL). The remaining residue gases are burned in the process for heat. Collectively, the licensable Demonstration Technology consists of everything inside the Technology Envelope as more fully described in APPENDIX 1 to this Agreement.

(B) Technology Rights

ENCOAL represents that is has obtained from SMC sufficient rights in the patented and unpatented technology, including copyrighted works and operating expertise, to enable ENCOAL to fulfill its obligations under the Repayment Agreement.

ARTICLE V — AMOUNT OF REPAYMENT

(A) The amount of the Participant's repayment obligation shall be based only on the sale, lease, or licensing of the Demonstration Technology, as defined in Article IV, in applications and for use at facilities located in the United States. The amount of repayment shall be 5 percent of the gross revenues from the sum of all royalties and licensing fees during

commercialization of the Demonstration Technology. Equipment sales/leases are not a revenue producing activity for the Participant and do not contribute to repayment.

For purposes of determining the amount of repayment, commercialization shall be deemed to have begun on the effective date of this Repayment Agreement or the day after commissioning of the first full scale commercial plant using the Demonstration Technology, whichever occurs later.

(B) License Fees

The Participant shall pay DOE an amount equal to 5 percent of the gross revenues from the aggregate license fees paid to ENCOAL, TEK-KOL, or any authorized licensor of TEK-KOL for use of the Demonstrated LFC Technology. In its License Agreement with TEK-KOL, the Participant requires that TEK-KOL include in all contracts or agreements with any entity which acquires the right to license the use of the Demonstrated LFC Technology, a provision requiring that all such license and sublicenses and associated revenues be reported on an annual basis to TEK-KOL. SMC and TEK-KOL have agreed to commercialize the Demonstration Technology on behalf of ENCOAL. TEK-KOL's agreement with the Participant includes an obligation to report all of this information to the Participant. The address of TEK-KOL's representative is as follows:

TEK-KOL Partnership
3366 N. Torrey Pines Court #220
La Jolla, CA 92037
Ph. (617) 452-0841

(C) Commercialization and Repayment Guarantee

SMC Performance Guarantee on behalf of ENCOAL for commercialization and repayment are included in Attachment A to this Repayment Agreement.

ARTICLE VI — SCHEDULE OF REPAYMENTS

Payments to DOE shall be calculated on an annual basis, and shall be due within 60 days after each 1-year period following the effective date of this Repayment Agreement.

ARTICLE VII — REPORTING AND RECORD RETENTION REQUIREMENTS

(A) Annual Report to DOE

Within 60 days after the end of each 1-year period, the Participant shall submit a written report to DOE which, for the 1-year period just elapsed, provides the applicable data described below:

(1) The total dollar amount of license fees and royalties paid for use of the Demonstration Technology;

(2) Quantities and descriptions of Demonstration Technology transactions under which license fees were paid;

(3) The total amount of revenue reported by each entity identified in ARTICLE V.

(4) The total amount owed and paid to DOE, and the amount of the DOE share remaining to be paid in succeeding years under this Repayment Agreement.

(B) Period of Retention

With respect to each annual report to DOE, the Participant shall retain, and shall contractually require TEK-KOL to retain, for the period of time prescribed in this paragraph, all related financial records, supporting documents, statistical records, and any other records the Participant reasonably considers to be pertinent to this Repayment Agreement. The period of required retention shall be from the date each such record is created or received by the Participant and TEK-KOL until 3 years after one of the following dates, whichever is earlier: the date the related annual report is received by DOE; or the date this Repayment Agreement expires or the final payment to DOE is received. If any claim, litigation, negotiation, investigation, audit, or other action involving the records starts before the expiration of the 3-year retention period, the Participant and TEK-KOL shall retain the records until such action is completed and all related issues are resolved, or until the end of the 3-year retention period, whichever is later. The Participant shall not be required to retain any records which have been transmitted to DOE by the Participant.

(C) Authorized Copies

Copies made by microfilm, photocopying, or similar methods may be substituted for original records. Records originally created by computer may be retained on an electronic medium, provided such medium is "read only" or is protected in such a manner that the electronic record can be authenticated as an original record.

(D) Access to Records

DOE and the Comptroller General of the United States, or any of their authorized representatives, shall have the right of access to any books, documents, papers, or other records (including those on electronic media) which are pertinent to this Repayment Agreement. The purpose of

such access is limited to the making of audits, examinations, excerpts, and transcripts. The right of access described in this paragraph shall last as long as the Participant retains records which are pertinent to this Repayment Agreement.

(E) Restrictions on Public Disclosure

The Federal Freedom of Information Act (5 U.S.C. § 552) does not apply to records the Participant is required to retain by the terms of this Repayment Agreement. Unless otherwise required by law or a court of competent jurisdiction, the Participant shall not be required to disclose such records to the public.

(F) Flow Down of Records Retention and Access Requirements

In any contract or other agreement subject to the reporting requirements described in Article V, Sections A and B, the Participant shall include clauses substantially similar to the records retention and access requirements set forth in sections (B) and (D) of this Article.

Evidence of Recipient Acceptance		Awarded By	
E. C. Summer	6-26-90		
Signature	Date	Signature	Date
E.C. Summer			
(Name)		(Name)	
President			
(Title)		(Title)	

Mr. BARKOFSKE. I will be glad to file that with—

Chairman JOHNSON. As you can tell from the preceding discussion, there are concerns about evenhandedness of public policy, and there are those who believe that this credit gives you all an unfair advantage against other sources of fuel.

Do you care to comment on that? I would by happy to hear your comments.

Mr. BARKOFSKE. Right now? Later, Madam, or right now?

Chairman JOHNSON. Yes. Right now.

Mr. BARKOFSKE. Oh, good.

We do not think the tax credit will unduly give advantage to this product. What it is doing is it is making an alternative available for people who want to have a supercompliance coal out there, that is able to be shipped across the country at reasonable rates, and burned in their power plant.

It is not going to, in any way, undercut any of the existing fuels. It simply gives the potential buyer for a utility, or an industrial complex, the advantage of being able to use an alternative source.

I would be silly if I stood here and said that it is going to be able to compete day in and day out with any of the other power plant sources.

If I might take just 1 minute. Let's take the ALCOA for example. Their aluminum plant is in Texas. We have lignite reserves adjacent to that plant. They also own and control some of those.

By putting the ENCOAL plant in between the lignite deposit and their aluminum plant, they would be able to avoid a processing step which is otherwise required in bringing that lignite into it. It is an ideal situation, it is one of those unique situations that the environment has improved, and once again, we are able to use a domestic source of power. That is just one instance of where it fits in.

This is not going to be a massive situation. I do not think anybody thought the clean coal technology projects were going to replace natural gas or coal.

We have over a billion tons of coal in our company, so we are not looking to replace all that. It simply fills a niche that we believe is out there, and that would bring to fruition this government program.

We have encouraged government, and company participation. This was a 50/50 deal between our company and the DOE, and we want to see it come to fruition.

Chairman JOHNSON. Thank you.

Mr. ZAHREN. I would also say the same thing with regard to landfill gas. Landfill gas contains approximately 50 percent of the methane content in natural gas. In order to clean it up and make it competitive with natural gas, for any use, whether it be in a boiler or as vehicle fuel, or to make electric power, what you have, is an expensive process.

Much of that technology is not proven yet. We have quotes from a number of chemical engineering firms, in the neighborhood of $1.5 to $2 per million BTUs for the cleanup cost of making landfill gas comparable to natural gas.

The amount of the credit today is 99-cents-per-million BTUs. That hardly makes us competitive with natural gas on a straight-

up basis, if it costs $1.50 to just clean the gas up, to be able to bring it to the point where it is even comparable to natural gas.

I would assume your economics are similar.

Mr. BARKOFSKE. Yes.

Mr. ZAHREN. It is not making us more competitive than conventional fuels. It is only subsidizing a part of the difference between the two.

Chairman JOHNSON. Thank you very much. I appreciate the quality of your testimony, and I appreciate this opportunity. It is too bad C–SPAN is not recording this kind of a hearing, because it gives people a lot more insight, I think, as we discuss each of these credits, as to the critical role that the Federal Government does play, and continues to play in both supporting troubled industries through hard times, and initiating creative responses to problems we face in the environment, or elsewhere, and responding to the educational needs of our people.

Thank you very much for your testimony, and with that, we will go to the next panel.

Mr. BARKOFSKE. Thank you very much, Madam Chairman.

Mr. ZAHREN. Thank you.

Chairman JOHNSON. Thank you.

Janet Tully, the director of community employment and training of Marriott International; Shepard Bailey, the director of tax, Pizza Hut; John Wright, president of Wright Foods of McAllen, Texas, on behalf of the National Restaurant Association; and Dave Edwards, vice president, associate relations, the A&P.

Janet Tully, would you proceed, please.

STATEMENT OF JANET M. TULLY, DIRECTOR OF COMMUNITY EMPLOYMENT AND TRAINING, MARRIOTT INTERNATIONAL, INC., WASHINGTON, DC; ON BEHALF OF THE COMMITTEE FOR EMPLOYMENT OPPORTUNITIES

Ms. TULLY. I am pleased to testify today on behalf of both Marriott International and the Committee for Employment Opportunities. My printed statement describes our group and the list of employers in it.

We have been working for months to seek remedies to cure the ills of the old TJTC, Targeted Job Tax Credit Program. Frankly, I was a little surprised at Mr. Ross' comments this morning because it dealt mostly with the old program, and we have all been working very hard, and we did speak with him about some of the new things that we are planning.

We are committed to a fundamentally changed model of the TJTC. We want everyone to look past the timeworn letters of TJTC and see the whole new concept.

I have managed TJTC for Marriott since 1979, so I have known this program inside and out, in all its incarnations. Please believe me when I say that the new Houghton-Rangel model would totally alter the focus of the employer in the most basic ways.

This fresh concept deals with the main criticism of TJTC head on. Would we hire those workers anyway?

The Houghton-Rangel model puts this matter to rest. All TJTC-eligible job applicants are preidentified by employers, and therefore, given extra consideration.

The new law would require that employers prescreen applicants to determine probable eligibility prior to the job offer, as part of the application process.

This kind of levels the playingfield. We are all looking for the best applicants for the job. Most TJTC-eligible folks are not going to be in that category.

By knowing that this person is TJTC-eligible, it will give them some preferential treatment, and they will be considered equally in the interview process.

Marriott welcomes that change. We hire over 50,000 workers a year, and upon passage of this bill we are planning to change all of our application forms.

TJTC prescreening questions will be printed on the first page, to make sure that this section is completed before the main application.

Most of the employers in the office of the CEO are planning to do the same thing. It will not be possible for us to issue a memo saying TJTC is back, it is business as usual. We, and all employers, will have to retrain all hiring managers regarding TJTC.

This will significantly change our hiring practices. At Marriott, our managers in the past always did seek TJTC-eligible people. We do outreach to different community-based organizations. We put job orders into the local job service. We work with the local disability organizations, and we have a lot of programs that were set up under this.

This will just increase our participation, once this renewal is passed.

The new Houghton-Rangel model would also encourage retention of these workers. We agree with Secretary Reich and Mr. Ross, that the credit can be backloaded to encourage employers to retain workers, provided that there is enough up front credit to offset the extra training costs.

The new TJTC would provide this backloading. In regard to retention, incidentally, the Treasury has expressed concern that some employers might let workers go after 1 year when they are no longer TJTC-eligible.

To be perfectly honest, I cannot imagine that an employer would deliberately turn over an experienced employee. Why would we, after spending 12 months training, coaching and counseling employees, deliberately let them go, just to start from scratch with a new, low-skilled, inexperienced TJTC worker? This makes no sense, and it is definitely not good business.

Training, coaching, and counseling. I cannot overemphasize how much costly time and effort is involved in hiring and keeping TJTC workers. This is why the credit has to offset the initial costs. The majority of TJTC-eligible people are folks who have little or no work history, minimal education, and minimal skills.

Many of these folks have not experienced much success in their lives. They expect to fail, and in many cases that is a self-fulfilling prophecy.

On occasion, our managers have even supplied new hires with alarm clocks so that they can get up on time. It did not seem to follow a logical path. They just said I did not wake up in time, and that is why they were late for work.

This experience teaches them the basic life skills that most of us take for granted.

One of the common causes for termination is excessive absenteeism. No call, no show, is a big problem. Coaching and counseling, and sitting down and explaining to these people how important it is for them to show up for work, and how, if you have a headache, that is not an acceptable excuse for not coming into work; how just missing a bus is not going to be an excuse.

If you are consistently late, it is not because the bus came early; it is because you did not leave your house on time.

We have to sit and work with these people, and spend a lot of extra time coaching them, in order to make them successful employees.

Without an incentive to offset the up front costs in doing this, most managers would not spend the time required.

Like most employers, Marriott credits the wage cost to the unit level. The logic is that even though a person may not be a 100 percent at first, at least with the credit it is not costing the unit the full wage.

We endorse the Houghton-Rangel model, which is user friendly, easily understood, reduces government administration, and it uses more objective eligibility standards.

Most importantly, the model fundamentally changes the focus of the program, gives a leg up to TJTC applicants, and fosters outreach to persons with barriers to employment.

That is my central message. I just want to comment on a couple of things that Mr. Ross spoke about this morning, and showed some of his concerns, and to show that we have addressed them.

One of his concerns was that we limit the potential for abuse of the program by targeting it on the truly disadvantaged.

This new program does target on the truly disadvantaged. It has more objective criteria, and focuses on persons eligible for means tested or public assistance programs.

Students on Pell grants, you are not going to find many Harvard graduates who went through on any Pell grants, are truly disadvantaged, and that is going to handle some of the abuse in the youth category.

They want to say that we should reduce the employer windfall. The new program addresses this concern with the prescreening. Of course, we need the blessing of EEOC, the Equal Employment Opportunity Commission, to make sure we are able to do that.

This is something that we would not have minded doing in the past, except for those concerned. I really believe that the employers are, in prescreening, going to make sure that they more than target the TJTC-eligible folk.

Improve the incentive to provide long-lasting jobs. I feel in backloading the credit we are going to make sure that that happens.

Thank you very much.

[The prepared statement and attachment follow:]

STATEMENT BY
JANET M. TULLY, MARRIOTT INTERNATIONAL
ON TARGETED JOBS TAX CREDIT
FOR
THE SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS

May 9, 1995

I am pleased to testify for both Marriott International and the Committee for Employment Opportunities. My printed statement describes our broad coalition of employers, associations and public interest groups. We have been working for months to seek remedies to cure the ills in the old TJTC program. We're committed to a **fundamentally changed model.** We want everyone to look past those timeworn letters **"TJTC"** and see a whole new concept. The old program was a job opportunities model. It allowed employers to hire first, then screen for eligibility based mainly on family income. The new model, based on a different core principle, moving people from welfare to work by encouraging employers to seek out, pre-identify, hire and **retain** people who currently or potentially depend on public assistance and turning them into productive taxpayers. **The focus has changed.** The new program focuses the hiring manager's attention on the eligible job applicant before the hiring decision is made. It focuses the supervisor's attention on integrating the new worker into the mainstream workplace. And it focuses the employer's attention on retaining the worker as the size of the credit increases over time.

I've managed TJTC for Marriott since 1979, so I've known this program in all its incarnations. Please believe me when I say that the new Houghton-Rangel model would **totally alter the focus of the employer in the most basic ways.**

This fresh concept deals with the main criticism of TJTC head-on---would we have hired these workers anyway? the Houghton-Rangel model puts this matter to rest: **All TJTC-eligible job applicants are pre-identified by employers and therefore given extra consideration. The new law would require that employers pre-screen applicants to determine probable eligibility prior to the job offer as part of the application process.**

Marriott will welcome this change. We hire over 50,000 workers a year, and upon passage of this bill we are planning changes to all of our application forms. TJTC pre-screening questions will be printed on the first page to make sure that this section is completed before the main application.

It won't be possible for us to issue a memo saying "TJTC is back, it's business as usual." We and all employers will have to retrain all hiring managers regarding TJTC. This will significantly change our hiring practices

The new Houghton-Rangel model would also encourage retention of these workers. We agree with Secretary Reich that the credit can be backloaded to encourage employers to retain workers, provided that there is enough upfront credit to offset the extra training costs. The New TJTC would provide a 35

percent credit for the first six months of wages, and 45 percent in the second six months, and that is adequate.

In regard to retention, incidentally, Treasury has expressed concern that some employers might let workers go after a year when they're no longer TJTC-eligible. To be perfectly honest, I can't imagine that employers would deliberately turn over experienced employees. Why would we, after spending 12 months training, coaching and counseling employees, deliberately let them go, just to start from scratch with a new, low-skilled, inexperienced TJTC worker? This makes no sense.

Training, coaching, counseling: I can't overemphasize how much costly time and effort is involved in hiring and keeping TJTC workers. This is why the credit has to offset the initial costs. The majority of TJTC-eligible people are folks who have little or no work history, minimal education, and minimal skills. Many of these folks have not experienced much success in their lives. They expect to fail, and in many cases that's a self-fulfilling prophecy. On occasion, our managers have supplied new hires with alarm clocks so that they can get up on time. This experience teaches them basic life skills that most of us take for granted. They have to learn that their behaviors affect their co-workers and their company, not only themselves. Dependability is a very important skill, which can be learned only on the job. If you don't show up for your shift, everyone has to work harder, to cover for you. You have to learn how to accept criticism, to learn that your supervisor is only trying to help you, not put you down. Lessons like these take time to learn, and they require skill and patience to teach.

Without an incentive to offset the upfront costs in doing this, most managers would not spend the time required. Like most employers, Marriott credits the wage cost to the unit level. The logic is that even though a person may not be 100 percent productive at first, at least with the credit it is not costing the unit the full wage.

We endorse the Houghton-Rangel model, which is user-friendly, easily understood, reduces government administration, and it uses more objective eligibility standards. But most importantly, the model fundamentally changes the focus of the program, gives a leg up to TJTC eligible applicants and fosters outreach to persons with barriers to employment, and that is my central message.

COMMITTEE FOR EMPLOYMENT OPPORTUNITIES

Supporting Organizations

Corporations

A & P

ARA Service, Inc.

Burger King

Circle K

Dayton Hudson Corporation

General Mills

JC Penney

Kelly Services

Kmart Corporation

Manor Care, Inc.

Marriott corporation

May Dept. Stores

McDonald's

Montgomery Ward

Pepsico/KFC/Pizza Hut/Taco Bell

Southland Corporation

Wendy's International

Trade Associations

American Hotel & Motel Assn.

Associated Builders & Contractors

Food Marketing Institute

National Assn. of Convenience Stores

National Council of Chain Restaurants

National Restaurant Association

National Retail Federation

National Employment Opportunities

Network (NEON)

TJTC Coalition

Chairman JOHNSON. Thank you for your excellent testimony. Something has happened to the lights. They are very useful because they do help to give us warning, and if the staff could start the light system, that would be helpful.

Mr. Bailey.

STATEMENT OF H. SHEPARD BAILEY, DIRECTOR OF TAX, PIZZA HUT, INC.; ON BEHALF OF THE NATIONAL COUNCIL OF CHAIN RESTAURANTS

Mr. BAILEY. Good afternoon, Madam Chairman. My name is Shepard Bailey. I am the director of tax at Pizza Hut, Inc., based in Wichita, Kansas, and I am here today on behalf of the National Council of Chain Restaurants in support of the enactment of a permanent targeted jobs tax credit.

Before I begin my presentation on Pizza Hut's past experiences with TJTC, I would like to emphasize that Pizza Hut is one of the largest employers of individuals from the groups targeted by the former TJTC Program.

As such, Pizza Hut is well aware of the concerns that have been raised with respect to certain aspects of the program, as well as the manner in which it was used by some employers, or consultants.

Pizza Hut, as well as Pepsico, Inc., through its other restaurant divisions, have been involved with other employers in providing recommendations to Congressmen Houghton and Rangel, of ways to develop an employer tax credit that would address these concerns.

Pizza Hut commends Congressmen Houghton and Rangel for developing the draft legislation you have before you today, and we look forward to working with these congressmen, as well as you, the Members of this subcommittee, to enact this important legislation.

TJTC is an effective and efficient hiring incentive. Since 1990, Pizza Hut has provided job opportunities to over 30,000 TJTC-eligible applicants. These job opportunities represent the all important first steps for inexperienced workers to acquire the most basic skills absolutely necessary to advance in today's competitive job market.

For the 5-year period just ended, Pizza Hut has experienced a compounded annual growth rate in TJTC hires of over 20 percent.

Pizza Hut is committed to finding new and innovative ways to reach out to individuals who might not otherwise have job opportunities made available to them.

One program, Jobs Plus, designed to seek out, accommodate, employ and train persons with disabilities in every Pizza Hut unit, is a clear example of how TJTC is used to achieve its intended result.

This initiative has allowed over 13,000 persons with severe disabilities to become productive members of our work force.

Today, due in large part to Jobs Plus, Pizza Hut is heralded as the Nation's leading employer of persons with severe disabilities.

As for many employers presently using TJTC, the tax credit provided by TJTC was an important factor in Pizza Hut starting the Jobs Plus Program.

Now we all know that today's marketplace demands that companies provide the best products at the lowest possible price.

For many companies, including Pizza Hut, labor expense represents the single largest component of their cost structure.

TJTC allows companies to offset the added cost of training individuals who have little or no work experience. TJTC gives restaurant managers the extra ability to hire and train individuals who need additional support, while still allowing the managers to control their labor costs.

The absence of TJTC will force companies to find new ways by which to reduce their labor expense, such as automation, thereby reducing the number of these "first job" opportunities.

Our strong endorsement of TJTC is evident throughout the Pizza Hut organization. In addition to our outreach programs, Pizza Hut has a full-time staff dedicated to providing assistance and training to our restaurant managers on how to better focus recruitment efforts on those groups that typically are more difficult to access, such as general assistance and AFDC recipients.

By promoting these types of corporate efforts, TJTC helps reduce the dependence on governmental support programs, a certain type of welfare reform, if you will.

Each year, Pizza Hut invests a significant amount of capital to promote program usage where it must occur, in our restaurants. To this end, we have developed an incentive program to reward our restaurant managers for successfully hiring and retaining TJTC employees.

Through the use of this bonus incentive, we have been able to achieve the tremendous growth mentioned earlier in my testimony.

These three ingredients—outreach, support staff, and incentive, have been the winning combination which allows Pizza Hut to be a leader in the hiring and retention of TJTC employees.

There is, however, a cost in real dollars, associated with each of these three elements. The presumption that TJTC is a windfall for business is without merit.

Much like any tax incentive, or economic stimulus, TJTC is a partial offset to the investment of real and incremental dollars.

In closing, I would like to leave you with these thoughts. I respectfully submit that this new TJTC is a good and sound program. It helps create that ever-important "first job" for thousands of our citizens each year.

TJTC's tax benefits support employers' most innovative outreach programs for the previously unemployed and for the profoundly disabled.

To promote employer commitment to the program, first, the new TJTC should be made a permanent part of the Tax Code. Second, the certification process should be uniform in all 50 States.

If Congress can do this, employers will be able to continue creating "first-job" opportunities for thousands of economically disadvantaged, or physically disabled citizens each year.

Thank you very much.

[The prepared statement follows:]

STATEMENT BY H. SHEPARD BAILEY
DIRECTOR - TAXES, PIZZA HUT, INC.
HOUSE COMMITTEE ON WAYS AND MEANS
OVERSIGHT SUBCOMMITTEE
MAY 9, 1995

Good morning. My name is Shep Bailey. I am the director of tax at Pizza Hut, Inc., based in Wichita, Kansas. I am appearing on behalf of the National Council of Chain Restaurants, in support of the enactment of a permanent Targeted Jobs Tax Credit (TJTC).

Before I begin my explanation of Pizza Hut's past experiences with TJTC, I would like to emphasize that Pizza Hut is one of the largest employers of individuals from the groups targeted by the former TJTC program. As such, we are naturally aware of the concerns that some have raised regarding certain aspects of that program, as well as the manner in which it was used by some employers. Pizza Hut, as well as PepsiCo, Inc. through its other restaurant divisions, has been involved with other employers to provide recommendations to Congressmen Houghton and Rangel of ways to develop a new employer tax credit which addresses those concerns. Pizza Hut commends Congressmen Houghton and Rangel for developing the draft legislation you have before you today. We look forward to working with Congressmen Houghton and Rangel, and you, the members of the Committee to enact this important legislation.

TJTC is an effective and efficient hiring incentive. Since 1990, Pizza Hut has provided job opportunities to over 30,000 TJTC eligible applicants. These job opportunities represent the all-important first steps for inexperienced workers to acquire the skills necessary to advance in today's competitive job market. For the 5-year period ended 12/31/94, Pizza Hut has experienced a compounded growth rate in TJTC hires of over 20%. This is in spite of the most recent 14-month hiatus in the program.

Pizza Hut is committed to finding new and innovative ways to reach out to individuals who might not otherwise have job opportunities available to them. One program, Jobs Plus, originally designed to designate one position in every Pizza Hut unit for persons with disabilities, is a clear example of how TJTC is used to achieve its intended result. This initiative has allowed over 13,000 persons with severe disabilities to become productive members of our workforce. Today, due in large part to Jobs Plus, Pizza Hut is heralded as the nation's leading employer of persons with severe disabilities. As for many employers presently using TJTC, the tax credit provided by the program was an important factor in Pizza Hut starting the Jobs Plus program.

Pizza Hut recently conducted a survey of our restaurant managers to determine overall satisfaction with the performance of employees with disabilities hired through Jobs Plus. The results were great. Ninety-seven percent of the managers reported that there were no performance problems with Jobs Plus employees. Additionally, 71% of the managers reported that their Jobs Plus employees had been sourced through a collaborative effort with an outside rehabilitation agency.

Two significant points are clearly based on the results of our Jobs Plus survey, 1) TJTC, through Jobs Plus, helped to dispel the myth that performance of employees with disabilities is unfavorable as compared to other employees, and 2) that TJTC is a vehicle by which the time gap between public employment training programs for those with disabilities, and their hiring by the private sector can be shortened.

Today's marketplace demands that companies provide the best products at the lowest possible price. For many companies, including Pizza Hut, labor expense represents the single largest component of their cost structure. TJTC allows companies to offset the added cost of training and turnover of individuals that have little or no work experience. The absence of TJTC will force companies to find new ways in which to reduce their labor expense, such as automation thereby reducing the need for people.

Unfortunately, the "on-again, off-again" approach to TJTC has been a barrier to Pizza Hut's effort to grow our program much beyond the 10% mark as a mix of our total employee base. Our restaurant managers are constantly on the lookout for ways in which to manage their costs. TJTC gives managers the extra ability to hire and train individuals who need additional support while still allowing the managers to control their labor costs.

Our strong endorsement of TJTC is evident throughout the Pizza Hut organization. In addition to our outreach programs, Pizza Hut has a full-time staff dedicated to providing assistance and training to our restaurant managers on how to better focus recruitment efforts on those groups that typically are more difficult to access, such as General Assistance and AFDC recipients. By promoting these types of corporate efforts, TJTC helps reduce the dependency on governmental support programs.

Our TJTC staff also works closely with the various state employment security agencies to reduce the often burdensome documentation required of employers to obtain certification. Our ability to streamline this part of the TJTC process has resulted in a material improvement in program usage at the restaurant level. Several states have sought out our assistance in developing a better mousetrap, thus encouraging more employers to embrace the program. This type of working relationship between the private sector and the states is critical due to the complexity caused by 50 states administering a single federal program in 50 individual ways.

Each year, Pizza Hut invests a significant amount of capital to promote program usage where it must occur, in our restaurants. To this end, we have an incentive program designed to reward our restaurant managers for successful hiring and retention of TJTC employees. Through the use of this bonus incentive, we have been able to achieve the tremendous growth mentioned earlier in my testimony.

These three ingredients, outreach, support staff, and incentive have been the winning combination which allows Pizza Hut to be a leader in the

hiring and retention of TJTC employees. There is, however a cost, in real dollars, associated with each of these three elements. The perception that TJTC is a "windfall" for business is invalid. Much like any tax incentive or economic stimulus, TJTC is an off-set to the investment of real dollars.

On eight occasions prior to today, Congress has improved upon the program to ensure the original legislative intent. To further promote utilization and long-range commitment, Congress could improve once again by taking the following actions. First, make the TJTC a permanent part of the tax code. Next, provide private sector employers relief from the fear of litigation through the development of an EEOC-approved, pre-job offer TJTC questionnaire. Both of these actions would then allow employers to make long range plans, as well as dedicate the resources, to support much needed outreach programs necessary for program success. And finally, develop a standardized certification process. This would eliminate the burden on employers caused by varying administrative procedures at the state level.

Thank you.

Chairman JOHNSON. Thank you, Mr. Bailey.
Mr. Wright.

STATEMENT OF JOHN WRIGHT, PRESIDENT, WRIGHT III FOODS, INC., MCALLEN, TEXAS; ON BEHALF OF NATIONAL RESTAURANT ASSOCIATION

Mr. WRIGHT. Thank you. My name is John Wright, and my wife, Melinda, and I, own Burger King franchises on the Mexican border in South Texas. We started our business with 1 restaurant in 1976 and have grown to 9 restaurants with 336 employees today. We have survived despite citrus freezes, hurricanes, oil spills, and peso devaluations in 1976 and 1982, and we are now enduring the effects of the devaluation of December 1994.

Our SMSA, standard metropolitan statistical area, has the highest unemployment rate in America, and the lowest per capita income. The population of Hidalgo, in Cameron County, Texas, is approximately 800,000, and is 85-percent Hispanic. The Rio Grande Valley is home to well over 100,000 U.S. citizens who are migrant workers.

Their seasonal employment too often locks them into a cycle of low education and poverty. One of the few ways to break this cycle is to provide incentives to private sector employers who hire these and other disadvantaged individuals, and provide them on-the-job training and work experience. Each year, in March and April, huge numbers of families leave their homes in South Texas to follow the agricultural crops in the north. As students leave with their families in April, their spring semester is ruined, and because they do not return until October, their fall semester is disrupted also. Too often, these families are forced onto public assistance between October and May, if not year around. These are the young people we were able to employ through the Targeted Job Tax Credit Program.

From 1986 through 1993, we used the TJTC Program, and our experience was gratifying. Through the offices of the Texas Employment Commission, we placed job orders, prescreened, interviewed, and hired numerous young people in this targeted group. With the TJTC Program, they got job experience that provided them a way to break out of the migrant population. Our organization is now filled with such employees, including production leaders, assistant managers, even restaurant managers, who came to us through this TJTC Program. They have learned the skills of teamwork, communication, coordination, and personal responsibility that are required in the workplace.

The restaurant business is unique in its requirement that employees master both the disciplines of production management and of retailing. In addition, every employee, regardless of their previous experience or lack thereof, learns to deal with our customers in ways that will bring them back to Burger King.

The 104th Congress should enact TJTC reform legislation which would create opportunities in the private sector for these and other high-risk young people. Those others in the restaurant business offer many disadvantaged individuals their first stable job, and their first stable social environment, so they can learn and grow.

TJTC is an excellent incentive to hire, train, and retain these youngsters. As an employer who stopped participating in the pro-

gram because of its complexity, I encourage you to establish a simplified process that would minimize the bureaucratic hurdles that now confront small business owners who want to participate. It should be administered through State employment commissions, thereby helping large and small employers, and expanding the number of disadvantaged individuals who benefit. The program should target, among others, less educated and less skilled workers.

This is a valuable program that should be revised, simplified, and retained.

Thank you.

Chairman JOHNSON. Thank you, Mr. Wright.

Mr. Edwards.

STATEMENT OF DAVID EDWARDS, VICE PRESIDENT, ASSOCIATE RELATIONS, GREAT ATLANTIC AND PACIFIC TEA CO. (A&P), MONTVALE, NEW JERSEY

Mr. EDWARDS. My name is Dave Edwards and I am vice president of Associate Relations for the Great Atlantic and Pacific Tea Co., headquartered in Montvale, New Jersey.

I appreciate this opportunity to testify on behalf of my company and the Food Marketing Institute.

A&P operates over 1,100 supermarkets in the United States. In addition to operating as A&P, we operate as Waldbaum's Food Mart in Connecticut and Massachusetts, Waldbaum's on Long Island, Food Emporium in Manhattan, Super Fresh in the Mid-Atlantic States, Kohl's in Milwaukee, and Farmer Jack in Michigan.

A&P's total employment in the United States exceeds 67,000. A&P has participated in the TJTC Program for many years, and I have managed the program at A&P since 1992.

The Food Marketing Institute, FMI's membership, is composed of large multistore chains, small regional firms, and independent supermarkets.

We recognize that there have been criticisms of the old TJTC Program, and would like to pledge our support for a new improved TJTC Program as outlined in the discussion draft offered by Congressmen Houghton and Rangel, and the work done by the Committee for employment opportunities.

Their changes offer improvements which will allow our industry to continue utilizing this effective program.

Strong local economies begin with strong neighborhoods. Supermarkets play an important role in creating and maintaining strong neighborhoods. They also provide many young people with their first work experience.

These characteristics provide supermarkets with the unique opportunity to play a leadership role in developing programs to address the social and economic challenges of the neighborhoods and communities they serve.

Many companies, including A&P, have found that a good way to increase store manager awareness and program support is to credit the store earning the tax credit with their TJTC dollars on the individual store profit and loss statement.

There is no doubt that this practice has contributed to the fact that TJTC new hires have longer retention rates than non-TJTC new hires.

This practice has the additional advantage of increasing the operating profits in locations that serve the TJTC-eligible community.

At times, these tax credits have made the difference in a decision to close a store or consider opening a new store in a specific location.

TJTC has encouraged retailers to operate stores in areas where many TJTC-eligible employees reside.

Many of these people are unable to travel in their neighborhoods. By our being there, we often provide the first job, and first formal training that many of these people ever receive.

TJTC has been the vehicle for many to take the first step from dependency to becoming a taxpayer.

The TJTC Program is one reason why more supermarkets operate today in depressed areas compared to two decades ago.

Supermarkets offer a wide variety of products at competitive prices. The reopening of inner city stores has made food and other staple items more affordable in areas where the need to stretch the purchasing power of dollars and food stamps is paramount.

The TJTC Program has served to make these stores more viable, and failure to continue the TJTC Program could result, over time, in more than a loss of jobs.

The issue is do you believe people in these categories should be helped? If so, who is better prepared to do it? Business or the government?

I think the answer is business, because we provide real jobs. TJTC has been one of the most cost efficient and effective programs for encouraging private sector employers to hire people who are not currently in the work force.

Over the years, many employers have come to realize that TJTC provides the incentives needed to cover the added costs of training and supervising disadvantaged workers, and that TJTC workers can do a good job.

The TJTC Program is an effective program that provides employment, especially in the inner cities, and it should be continued.

We support the changes proposed by the Committee for Employment Opportunities and the Houghton-Rangel discussion draft.

Once adopted, these changes will allow the program to continue to be viable for our industry, as well as potential future TJTC applicants.

Thank you very much for this opportunity, and I would be pleased to answer questions at this time.

Chairman JOHNSON. I hear that you are all in support of the reform program.

Do you support the radically simple approach, where only those who qualified for means-tested programs or Pell grants would be eligible?

You can get back to me on this. I mean, the reason for looking at this, if we are going to do anything in this area, is that it is very hard for small businesses to participate in a program that requires precertification, preidentification, or making sure somebody qualifies.

Since we want to simplify this, you need to think about what would be the impact on your programs if you were only allowed to accept people for this program who were either eligible for a means-tested program or for Pell grants.

There may be some other examples. Certainly disability programs, voc-rehab programs, and things like that, would qualify. You need to think about that.

Then what would be the impact of, with a backloaded requirement, particularly on small business, and particularly on neighborhood businesses, that don't have a backup of an A&P behind them. I mean, what are the accounting problems here. All of you, except for you, Mr. Wright—I am not sure—are part of bigger chains that have the sophistication to just give you the information.

What does backloading do to the participation of small businesses in this program?

Ms. TULLY. I think that the basic, the 35 percent, up front, will help offset the training programs on that, and the backloading will cover that. Mostly, their tax people will take care of it later on, but they know at least that they are paying them reduced wages in the beginning, when they are expending that extra effort.

Chairman JOHNSON. In other words, it is a problem for small businesses because they do not have a tax person.

Ms. TULLY. They do not have a human resource office. Yes. There is no question about that.

Chairman JOHNSON. Yes. That is right. Backloading does make it more complicated. While it could be an incentive to retaining the employee, maybe there are other ways of retaining an employee without getting into a level of complexity that would make it hard for small businesses to participate.

One of the things that has been significant about this program, and just from the information that I—and I am not an expert—but it has been over the time, clearer and clearer to me, and a greater concern, it is the big corporations that are able to do this.

If it is going to be primarily a big corporation program, which it might well be—and it does not mean that it would not be useful—should we require, to qualify for these benefits, that a company should actively recruit? They should actively recruit, actually go into the neighborhoods where there are the majority of people who need this kind of support.

Should we make that a qualification for participating in the program, for a company to demonstrate that they have an affirmative recruitment program?

Mr. EDWARDS. We do not think you should. Many of the people that are in these categories are very reluctant to go to places where we would recruit.

They are uncomfortable with the process. They know where the local store, or the local business facility is in their community, and they may know somebody who works there.

They are more comfortable, in many cases, going right to the location to apply for the job, and I think if you specifically eliminated those that came directly to the store location, you would effectively eliminate many of the people that the program tries to get at.

Chairman JOHNSON. Other comments?

I was not suggesting that you would not also be able to hire off the street.

One of the things that has been remarkable about affirmative action, the whole affirmative action approach, is not so much the quota system, but the requirement on employers to affirmatively recruit, and that has meant that jobs are advertised in areas where they have not been advertised, and has provided really much greater access.

It is really that kind of recruitment effort that Pizza Hut has made toward the disabled, but it could easily be made in neighborhoods of certain cities.

Beyond the walk-in eligibility, and certainly the neighborhood service, that employers using this credit could provide, the issue of recruitment does interest me.

I am going to yield to my colleague, Mr. Portman.

Mr. PORTMAN. I thank the Chairwoman and thank you all for being here today.

It was very interesting for me to hear your statements, from personal experience.

There are a number of studies, of course, that are very troubling to me and to others who are fiscal conservatives, trying to figure out ways to decrease our budget deficits. This program, net, maybe $250 million a year. Perhaps you can correct me.

It is a revenue hit to the government as are all of our tax credits. We want to make sure it works and works properly. If you look at the GAO, General Accounting Office, study, look at the Department of Labor studies, they would indicate that many of these people would be hired anyway.

That conclusion is only affirmed in my district among the employers with whom I have spoken. They have come forward, these employers, and said we get the tax credit, we are happy to receive that from the Federal Government, but, frankly, we would hire these people anyway.

This is a program that I am very skeptical about. I was very pleased to learn, a couple of days ago, about the reforms, and I have now had a chance to look at them, and then to hear your comments, all four of you supporting the reforms being promoted by Mr. Houghton and Mr. Rangel, and I am very pleased to see that.

I guess if I could ask a couple questions about the reforms and see whether they get at the kinds of problems that I perceive that are in the program currently.

Ms. Tully, you talked about the importance of the screening, and I guess you are indicating that the so-called windfall in the program now, which again I think has been evidenced by some of the studies, and again, some anecdotal evidence, would not occur with screening because people would not be hiring folks, they would otherwise hire, that in fact they would only be hiring people eligible for the credit because they would have to go through a certification process in advance.

Why do you think that the windfall would not continue to be there?

Ms. TULLY. You know, right now, one big problem that we have is the job market is becoming very small. We have now, at Marriott, people who are with college degrees, applying for secretarial

positions, for entry-level positions as bellmen, front-desk clerks. It is a very competitive job market out there.

These folks are competing with college graduates for entry-level positions. When you are saying we would hire these people anyway, I cannot totally agree with that. I do not think we would be hiring these people anyway.

I just want to say, we really do not totally agree with the OIG, Office of Inspector General, study. I frankly believe in some cases, when you know what your outcome is going to be, and you ask questions that will give you the kind of outcome you want, then you have the kind of report you want.

That is how I feel about the way the particular survey was conducted.

I do not feel now, and it is only now with welfare reform, we are saying that people are going to be 2 years on and out—where are these people going to go?

They are going to have to find jobs. And where are the people with the jobs trying to—

Mr. PORTMAN. Let's back up a moment. You would dispute the findings—

Ms. TULLY. I would dispute those findings; yes, sir.

Mr. PORTMAN [continuing]. The 1994 audit findings of the 92 percent. You would dispute the premise of my question, which was assuming the current program leads to people receiving a credit who would hire these same employees anyway, why are we giving the credit and how can we improve the program.

Your answer to that is that you do not agree with my premise. You think that in fact there is not a problem in the current system with regards to folks being hired anyway?

Ms. TULLY. No. I agree that there is some problem in the current system. I agree with that. I do not feel that all the people hired under TJTC in the past would have been hired anyway. I do feel now that—

Mr. PORTMAN. Instead of 92 percent, you think it is closer to 50 percent? What would your gut tell you?

Ms. TULLY. I can only speak for Marriott, and I know that we have a lot of outreach programs for people we have hired, who probably would not have had the opportunity, had we not been involved in these outreach programs because of the targeted job tax credit. Definitely with that. I feel very strongly that prescreening will make sure that employers give preferential treatment up front.

Something we would have liked to have done in the past is to make sure that all the people that we are hiring, that are TJTC-eligible, to give them an extra chance, knowing, of course, that when you are hiring a TJTC person, you are going to spend a lot of time and effort, up front, coaching and counseling, and working for these people.

Some of these people are going to be well worth it, given the opportunity, and that is really what TJTC is about, is actually giving these people the opportunity, making us spend a little bit of extra time, and not just saying, "Hey, you just did not make it, goodbye, you are out of here."

The manager is going to spend some extra time working with these folks to get them over that first hurdle.

Mr. PORTMAN. Mr. Bailey is physically moving back and forth in his chair as if he might want to say something. I think you understand my question and my concern.

Do you have a response to it?

Mr. BAILEY. Yes. Aside from what some have called abuses, whereby wholesale attempts are made by some users to certify within certain categories—I have a fundamental problem with this being characterized as corporate windfall, or corporate welfare.

I think that in fact, as the law is intended, TJTC is designed to provide a level footing, a level playingfield for individuals that otherwise might not have it, and at the same time protect or compensate the employer for taking that additional measure of risk.

If the program is administered, whether we are talking the old program or the new program, in the way in which it was intended, absolutely, I have a fundamental problem with regarding it as corporate welfare, or a corporate windfall.

Mr. PORTMAN. Again, just very briefly—I do not know how much time I have, Madam Chairwoman—but I will just restate the fundamental concern, and that is that many of these people would have been hired anyway, whether you believe it is 92 percent or 50 percent.

Why should you get a tax credit when your competitor, or another business, is not in your line of work, does not get a tax credit for hiring these same people? That many of these entry level jobs go begging now. In my area, we have about 3.3-percent unemployment.

Our white-collar problem, incidentally, Ms. Tully, is probably more dramatic in my area right now because of the changes at the middle management level out weighing the entry level. That is our problem.

Those people get no support from the Federal Government. In fact they go to the employment services, which is geared toward blue collar and toward entry level, and they are not getting any help.

With the scarce Federal dollar, in fact we are in a situation where we have no dollars, so everything we are giving, we are borrowing to give to corporations.

The question is, how can the program be streamlined to make it work better to handle that concern?

That is my question. I am not calling it corporate welfare. I did not use the word windfall. That was a term used in the study, and the administration has used it.

The fundamental premise I think continues to be true, that at least some of these people, maybe it is not 92 percent, maybe it is 50 percent, would have been hired anyway in the course of ordinary business.

Why should you be receiving a tax credit to do that? I think what Pizza Hut has done with the disabled community is exceptional; that sort of outreach. Maybe, that is required, as the Chairwoman indicates.

Maybe, that should be part of the Federal requirement, should the tax credit be available. Those are the kinds of questions that I am going to have over the next several weeks as we look at the program.

Do you have any comments?

Mr. EDWARDS. Yes. Certainly, in any case, some of the people, no matter what you do, the TJTC-eligible person, at times, is going to be your best candidate.

There is never going to be a program where you would bring in 100 people, and say that there might not be somebody that was TJTC-eligible, that would not have been hired anyway.

The program is never going to be 100 percent perfect. But the prescreening is certainly going to level the playingfield more toward the TJTC-eligible person.

While you could say that some might be hired anyway, the new program will insure many more targeted individuals will be hired. We think that makes a pretty good return on investment for a fiscal conservative like yourself.

Mr. PORTMAN. A good answer.

Chairman JOHNSON. Mr. Ramstad.

Mr. RAMSTAD. Thank you, Madam Chair, I want to applaud your leadership in calling this hearing today on the expiring tax provisions under consideration.

I certainly agree with much of what has been said, that the process under which these items are extended every few months, to put it very mildly, makes business planning extremely difficult. I mean, it is absurd, in terms of any long-range planning for business, not to know the rules of the game, so to speak.

I am hopeful we can deal with each of these provisions this year on a permanent basis.

I would like to ask any of the Members of this panel a couple of questions.

First of all, I am curious as to your reaction to Doug Ross' testimony this morning from the Labor Department, which I assume is the administration's position.

Ms. Tully, or Mr. Bailey, Mr. Wright, Mr. Edwards, would you care to comment?

Mr. BAILEY. I would be glad to.

I think that Mr. Ross' testimony seems to call for the solutions which in fact have been incorporated in Congressmen Houghton and Rangel's draft legislation, and in fact seemed to be a relatively strong endorsement of the very elements in this new draft legislation, not getting into whether I necessarily agree with Mr. Ross' criticisms of the old program.

The things that Mr. Ross is recommending as improvements, as ways to craft this legislation in such a fashion that he would feel comfortable, and the administration would feel comfortable in supporting, are in fact elements of the new draft legislation. I am quite comfortable with his recommendations.

Mr. RAMSTAD. That was precisely my question, whether the critique that he leveled is addressed by the elements of the legislation before us, Mr. Houghton's bill.

Do you agree with that, Ms. Tully?

Ms. TULLY. Very much so. I believe they are.

Mr. RAMSTAD. I see the other two witnesses nodding affirmatively.

Let me ask you a question Mr. Wright. I am just curious. Even though you no longer participate in the program, have you continued hiring individuals from the targeted group?

Mr. WRIGHT. We got out of the program due to the complexity of it.

To respond to Congressman Portman's question a minute ago, we are in an area where given the language and life skills of the TJTC population, we would not ordinarily hire from this group.

These are young people who go to both of your States in the spring of the year and return to the Rio Grande Valley in the fall of the year.

They do not have the life skills that we talked about. No one in their family has ever had a checking account. English is their second language. These are clearly people who ought to be targeted by a Federal program. They would not ordinarily comply with those requirements that Burger King or my company would have.

Mr. RAMSTAD. Well, I thank you, Mr. Wright, for that response.

I just want to conclude, Madam Chair, by saying that I, too, classify myself, or characterize myself as a fiscal conservative. I think my record supports that characterization.

My bias is in favor of revamping this, along the lines of the Houghton bill. I think you put it best, Mr. Edwards, you said that business can do it a lot better than government. I think that, succinctly, is the reason why we should give this legislation every serious consideration.

I want to thank the witnesses for being here today.

Chairman JOHNSON. I would like to thank the witnesses also. Your experience is very helpful to us.

The next panel will be Susan Oven, manager of the targeted jobs tax credit services for Dayton Hudson Corp. in Minneapolis; James Hubbard, the director of the National Economic Commission of the American Legion; and Scott Shipman, senior manager, government affairs, Shipman, Maison and Associations of Chicago.

While the panel is assembling, I would like to yield to my colleague from Minnesota.

Mr. RAMSTAD. Thank you again, Madam Chair.

I want to welcome this next panel, particularly Ms. Oven, Susan Oven, who represents the International Mass Retail Association. As you said, Ms. Oven is a manager of TJTC services at Dayton Hudson in Minneapolis and has provided me with important input on this program.

I know that Dayton Hudson is a very active participant in this program, having hired, Madam Chair, over 138,000 TJTC-eligible individuals over the last 10 years.

So given this experience and this tremendous buildup, Ms. Oven is in an excellent position to give our Committee insight today, and I really appreciate your coming here today, Susan. It's good to see you again. And welcome to all the witnesses.

Chairman JOHNSON. Thank you. Welcome, Ms. Oven, you may proceed.

STATEMENT OF SUSAN OVEN, MANAGER, TARGETED JOBS TAX CREDIT SERVICES, DAYTON HUDSON CORP., MINNEAPOLIS, MINNESOTA; ON BEHALF OF INTERNATIONAL MASS RETAIL ASSOCIATION AND NATIONAL RETAIL FEDERATION

Ms. HUDSON. Thank you.

It is my pleasure to speak to the Committee today in support of the revised TJTC Program. As Congressman Ramstad indicated, I have been involved with the TJTC Program at Dayton Hudson since 1988.

It is my job to help our stores with all aspects of managing this program. Basically, I am where the rubber meets the road. When the law is passed, it is my job to see that it is implemented, correctly and accurately, at all our stores.

I have submitted written testimony, and what I would like to talk to you about today is some of my experiences that I think illustrate the benefits of this program.

I am here today not only on behalf of my employer, but I speak also for the National Retail Federation, and the International Mass Retail Association.

As retailers, I think that we all are extremely mindful of the need to maintain the health of our economy.

If consumers in our economy are not willing to spend, we are out of business. When I speak in support of the targeted jobs tax credit, I am mindful that we want a program that works in the overall economy. We do feel that this is such a program, and has been for us.

Let me tell you a little bit about my experiences with TJTC as an employer. My job is to help our stores find and recruit TJTC-eligibles, and my written testimony speaks to that overall goal. I want to tell you what it is like to be an employer and hire a TJTC-eligible person.

I am going to tell you about a couple people that I think will show you what happens at that employer-employee relationship.

The first young woman I want to tell you about came to us from a YWCA Teen Mom Program, a program designed to get young mothers off of welfare. She was a student going to school to study nursing, in a nursing assistant program, and worked for me part-time in a telephone capacity.

From the time that she was hired, she began learning the job functions. It was apparent that she was a bright young woman.

A training program was not an issue for her. Listen to some of the things that she did not know. She did not know that you needed to come to work every day that you were scheduled.

She did not know that you needed to come to work on time. She did not know that if you were going to be late, or needed to call in sick, you needed to do that before your shift started.

Those sound like very elementary things for an employee, or a potential employee to know. This young woman had no role models. There was no one in her family that had a job. This was her first job.

There was no way that she was going to know those things before she came to work for us.

Janet Tully referred to the coaching and counseling that you go through with a new employee. Normally, most companies have a probationary period. In our case, an employee is expected to be up to speed in the first month.

I would say it was easily the first 3 months. This young woman got to the point where she was all of the expectations that we had for our employees, things that were a mystery to her when she first came, no longer were.

I think that the time that we spent with her is fairly typical of what an employer goes through with a TJTC-eligible person, and time is money.

No employer is going to choose an expensive hire without an incentive. They are going to look for the best employee at the lowest cost to them.

I will tell you about another young woman that still works for me. The first young woman did graduate from school and went on to a job in her field.

By the time she left, she was a wonderful employee, and we hated to lose her. I will tell you about someone that still works for me.

She came to us from State Services for the Blind. She is vision-impaired because of a sight loss from Lupus. She uses a special computer screen that enlarges text, so she can see printed words on her computer screen and do her job in that fashion.

Her biggest obstacle was not her vision, or lack of vision. Her biggest obstacle was really lack of confidence. This was her first job also, and she had lost her vision at a fairly young age. She was very frightened to come to work for us.

Despite the fact that she had support from State Services for the Blind, and we had recruited her—so she should have known that we wanted her as an employee, and were willing to go the extra mile to assimilate her into the work force—it was still a tough learning period for her.

Ultimately, we placed her in charge of all of our training, and actually, for the last few years, she has either done all of the training, or trained the trainer in our department.

Her abilities eventually outstripped her disabilities. I just want to summarize and say that I think the investment that this tax credit encourages employers to make for the truly disadvantaged in our society is a perfect fit with what the Congress is looking to do in terms of welfare to work progression.

I urge your support of the program, because I think it will make a valuable contribution toward that goal.

Thank you.

[The prepared statement follows:]

STATEMENT OF SUSAN OVEN
MANAGER, TJTC SERVICES DAYTON HUDSON CORPORATION
ON BEHALF OF INTERNATIONAL MASS RETAIL ASSOCIATION AND
NATIONAL RETAIL FEDERATION

Madam Chairman, Committee Members,

My name is Susan Oven. I am the Manager of TJTC Services for the Dayton Hudson Corporation, headquartered in Minneapolis, Minnesota.

I am testifying on behalf of the International Mass Retail Association (IMRA). IMRA represents more than 170 mass retailers, including discount department stores, warehouse clubs, and off-price stores, as well as 570 major suppliers. IMRA's retail members operate more than 54,000 retail stores and employ over a million individuals. In terms of sales volume, IMRA's members represent the vast majority of the $245 billion mass retail industry in the United States.

The discount retail sector is often referred to as the "new engine" for job creation. Since 1991, the number of jobs in the discount retail industry alone increased over 48% and has represented over 20% of job growth in the U.S. since the economic recovery which began in 1991. The number and nature of retail jobs has caused the Targeted Jobs Tax Credit offering to be a real factor in retailers' willingness and ability to employ TJTC eligible individuals.

Dayton Hudson Corporation, my employer and a member of IMRA, is the nation's 15th largest employer, with about 175,000 employees. Our operating companies include Target stores (an upscale discount retailer), and several department store companies, including Mervyn's, Marshall Field's, Hudson's and Dayton's. We operate over 930 retail stores in 33 states.

In Dayton Hudson alone, since 1984, we have utilized the Targeted Jobs Tax Credit program as an incentive to seek out, hire, train and retain over 120,000 TJTC-eligible individuals.

We rely on TJTC to help offset the incremental costs of hiring and training individuals who do not come "work ready." Without TJTC, we would be far less likely to hire, train and retain most of those who are participants in the program. (When we refer to individuals as not "work ready," we mean those who do not have experience, training, or a track record of being at work at scheduled times, who do not have basic customer service skills, or who cannot perform entry-level job requirements without extra training and investment on our part.) TJTC has motivated our hiring, training, and retention of such individuals.

In our efforts to utilize the TJTC offering, we have, for 10 years, maintained an internal staff to work with all of our stores on TJTC, to develop relations with state employment agencies, to educate our hiring managers and to give evidence to our entire company of the value of our being active participants in TJTC.

This committee and other members of Congress are now deliberating on the alternatives of continuing or ending this program.

There are several reasons we find TJTC to be effective in its purposes:
First, TJTC places the incentive to hire with the employer. While the hiring manager does not know for a fact that a given applicant is TJTC qualified, that manager looking at a given application form has a very clear indication of that qualification (e.g. periods of unemployment, lack of work experience, spotty employment history, etc.).

Second, once an individual is hired and working, the employee's TJTC qualification is known, and the TJTC credit has a significant influence on our willingness to retain eligible employees.

Third, because of the TJTC credit, every district of our various businesses has direct contact with numerous local agencies which help place disabled workers, AFDC recipients, and members of other under-employed groups. We also have a national agreement with GoodWill Industries to place their candidates, many or most of whom are TJTC eligible.

In short, TJTC is an important factor in our efforts to hire, train, and retain those eligible under TJTC regulations.

What we hear you asking is, "Does TJTC truly result in the hiring, training, and retention of individuals whom you otherwise would not hire, train and retain?"

Our answer is: yes. I will briefly address each of these phases of employment.

1. Hiring

   It would be helpful if we were allowed to determine eligibility prior to employment offer. But as stated earlier, we have become skilled at "guessing" and, in fact, have a clear record of employing TJTC eligibles.

2. Training

   We are more patient and give added effort to the development of job skills in TJTC eligibles because of financial incentives offered through TJTC.

3. Retention

   Our willingness to continue employment of TJTC eligibles is greatly increased, in spite of skills deficiencies, as a direct result of the TJTC program.

The off-again/on-again history of the program has been disruptive to the optimal fulfillment of the objectives of TJTC. If such intermittence continues, it will erode further the willingness of businesses and involved government agencies to give it appropriate support.

Therefore, we argue not only that TJTC is effective and should be renewed prior to the December 31, 1994 expiration date, but also that you give TJTC either permanent status or a long-term life of five to ten years.

If Congress contemplates substantive changes in a renewed TJTC program, representatives of our company would be eager to be of counsel to you and your staff organizations on issues of concern.

Thank you, Mr. Chairman, for this opportunity to testify in favor of TJTC being renewed on a permanent or long-term basis.

Chairman JOHNSON. Thank you very much for your excellent comments.

Mr. Hubbard.

STATEMENT OF JAMES B. HUBBARD, DIRECTOR, NATIONAL ECONOMIC COMMISSION, AMERICAN LEGION, WASHINGTON, DC

Mr. HUBBARD. Thank you, Madam Chair, for this opportunity to testify on behalf of our 3.1 million members.

I am here not as an employer representative, but as the representative of a constituency that exists out there, a lot of whom need help.

Let me summarize, briefly. We know that black and Hispanic veterans experience higher rates of unemployment than their white counterparts.

We know that a black male veteran is twice as likely to suffer the rigors of unemployment than a white male veteran.

Of all the veterans with a disability rating of 60 percent or more, over two-thirds are out of the work force. The unemployment rate for veterans, as a group, is below that for the population in general; but the unemployment rate for male veterans between 20 and 35 years old is up to 11.8 percent.

There is strong evidence that the subsidy involved in the operation of TJTC is seriously overstated. If you put a veteran to work, or anybody on TJTC, to work earlier, or at all, than they otherwise would have gone to work—welfare payments, unemployment compensation, other general assistance payments are significantly reduced. That is a cost savings.

We believe that there needs to be a study done on this, to get away from this static analysis that we do when we examine the cost of these things.

Let me put something else in perspective. The airline folks were saying that a 4.2 cent additional tax on airline fuel is going to cost jobs in the industry. In fact somebody mentioned Boeing losing 50,000 people.

That makes headlines. The Armed Forces lay off 250,000 on an annual basis, and nobody knows it, and nobody seems to care.

Half of these people released are married. They will need immediate assistance in order to provide for their families. More than 30 percent of them are minorities. Some of them will return to the inner cities where unemployment is endemic.

Eleven percent of those people released from the armed forces are women. In some cases, the spouses of former service people will need assistance in finding meaningful employment.

With the exception of the very limited funds available under the Job Training Partnership Act, title IV(c), TJTC is one of the few tools available to employers across the nation to help these people coming out of the armed forces.

In conclusion, Madam Chair, we believe that TJTC is one of the most efficient and cost-effective of Federal programs.

With TJTC nobody loses. Economically disadvantaged workers gain an opportunity to demonstrate their ability to become productive members of society. They move toward financial independence.

Employers are able to hire a capable work force and receive a tax credit. The public assistance rolls are reduced as workers move from welfare and unemployment roles to the tax roles.

We would like to see an extension of TJTC, with the particular model being the reforms introduced by Mr. Houghton and Mr. Rangel.

Thank you, Madam Chair.

[The prepared statement follows:]

STATEMENT OF JAMES B. HUBBARD
DIRECTOR, NATIONAL ECONOMIC COMMISSION
THE AMERICAN LEGION
TO
SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

May 9, 1995

The American Legion is pleased to present to this committee the views of our 3.1 million members on the Targeted Jobs Tax Credit proposal before the Congress. In the best of all possible worlds, we would like to see this program made permanent. As this committee is aware, the checkered history of TJTC over the past several years has caused the program to be much less effective than would be the case if it were permanent. Each hiatus between extensions causes more confusion and more employers drop out causing fewer veterans to be hired.

We are extremely pleased that the proposal expands the eligibility from serving only Vietnam era veterans to veterans who are economically disadvantaged. It is right and proper that this nation should offer an employment subsidy targeted at workers or potential workers who have borne the burden of unemployment at a rate higher than the rest of society. In our view, the historical imbalance seen in the distribution of unemployment can only be remedied by the creation and continuance of incentives for employers to make extra efforts to hire those targeted workers, which include the disabled, minorities, veterans and others. TJTC has served these groups well by creating an "employment advantage" for these groups.

Veterans have been one of the beneficiary groups served by TJTC for some very good reasons. Apart from the fact that these men and women donated a portion of their lives, and in some cases risked their lives for our country, some of them are now chronically unemployed. They need the assistance of this nation and TJTC can help. The data tabulated by the Department of Labor and published as WORKFORCE 2000 AND AMERICA'S VETERANS is still valid. Consider the following from that report:

Black and Hispanic veterans experience higher rates of unemployment than their white counterparts.

A black male veteran is more than twice as likely to suffer the rigors of unemployment than a white male veteran.

Of all the veterans with a disability rating of 60% or higher, more than two-thirds are out of the labor force.

While the unemployment rate for veterans is somewhat below that for the population in general, the unemployment rate for male veterans between 20-35 years is up to 11.8% according to a Department of Labor Survey.

The Targeted Jobs Tax Credit works. The Wharton School of Business at the University of Pennsylvania has concluded that the program has been effective in fulfilling the objectives for which it was intended. TJTC also works for veterans. Between twenty-five and thirty thousand veterans per year have obtained meaningful employment through the TJTC program.

There is also strong evidence that the subsidy involved in the operation of TJTC is seriously overstated. It is very likely that welfare payments, unemployment compensation, and other general assistance payments made to unemployed workers are significantly reduced when TJTC induces employers to recruit and hire eligible people. We believe that the Departments of Labor and Health and Human Services should jointly do a study of the dollar amount of transfer payments saved by those employed through the TJTC program.

This committee should also be aware that as the United States military begins to grow substantially smaller, there will be more veterans on the street seeking work. In the next five years, the size of the armed forces will be reduced by approximately 500,000 people. Over one half of the people released are married, and will need immediate assistance in finding employment in order to meet the responsibilities of caring for a family. More than 30% are minorities, some of whom will return to the inner cities where unemployment is endemic. About 11% of those released will be women. In some cases, spouses of former service men and women will also need assistance in finding meaningful employment. With the exception of the very limited funds available under Title IV-C of the Job Training Partnership Act ($9.0 million), TJTC is one of the only tools available to the employment services across the nation to help these people. Funding for a program under the Service Members Occupational Conversion and Training Act has run out.We are not concerned with those members of the military who have learned a marketable skill while on active duty. We are concerned with those who have served their country in the infantry, armor or artillery branches of the Army or the Marine Corps or in the Air Force, Navy or Coast Guard where the skills learned are not directly transferrable to the civilian workforce. Many of these people are minorities from inner cities who will qualify for TJTC. As I have mentioned before, many of these same people are married with families. TJTC can be an important tool for them.

The American Legion has concluded, Mr. Chairman, that TJTC is one of the most efficient and cost effective of all federal assistance programs. With TJTC nobody loses. Economically disadvantaged workers gain an opportunity to demonstrate their ability to become productive members of society and to move toward financial independence. Employers are able to hire a capable work force and receive a tax credit. The nation's public assistance rolls are reduced as workers move from the welfare and unemployment rolls to the tax rolls. The American Legion respectfully urges a permanent extension of the TJTC program.

Chairman JOHNSON. Thank you very much, Mr. Hubbard.
Mr. Shipman.

STATEMENT OF SCOTT D. SHIPMAN, SENIOR MANAGER, GOVERNMENT AFFAIRS DEPARTMENT, SHIPMAN, MAISON & ASSOCIATES, LTD., CHICAGO, ILLINOIS; ACCOMPANIED BY R. WALTER SHIPMAN, PRESIDENT, SHIPMAN, MAISON & ASSOCIATES, LTD.

Mr. SHIPMAN. Thank you, Chairman Johnson.

Madam Chairman, Members of the Committee, my name is Scott Shipman. I am the government affairs manager with the firm of Shipman, Maison & Associates. We are a tax financial services firm based in Chicago.

Through our CEO, we have been involved with the TJTC Program since 1978, and I think of people providing testimony today, we might bring a little different perspective to this hearing, the idea being we suggest using software systems to help manage the administration of the TJTC Program, such as streamlining of the TJTC process, if you will, could help this program be more beneficial not only to the applicants but to the State governments currently administering TJTC, as well as the employers.

Madam Chairman, through use of software, you can use this software at the local, State, or Federal level, and provide pools to job applicants, if you will, ready to go to refer to job placements, currently, that employers need.

I believe Congressman Houghton himself suggested the process, the mechanics of this system, are what I would call "lurchy." They take a long time. It is very inefficient and it takes taxpayers' money to do such a program.

What we are here to suggest, and inform you of, is that maybe software might be a good way to help this program along through more efficiently and more economically managing TJTC.

Specifically this system can help certify a TJTC applicant in 10 minutes. That is pretty quick. In some States, that takes months, and naturally, the applicant has to fill out lots of paperwork and the employers are forced to bear a burden of waiting, and trying, and coaching to get this paperwork processed.

Also, many of the States are just completely inundated with paper. Some of it is accurate, some of it is not. Some of it is not legible. It is very burdensome to them, seeing how their funding is cut and their staffs are cut every year by the discontinued use of this program.

Through software, and through the use of suggesting applicant pools to the employers, the system would be smoother and more easily managed.

For example, this system would fit in very nicely with the Department of Labor's one-stop shopping concept.

You would have in the corner of a one-stop shopping center a TJTC booth, where an applicant could go, be prescreened, vouchered and certified, again, in less than 10 minutes.

If you will allow this illustration. Software systems could help the administration of this program in much the same way ATMs help banking. That is, provide accurate, faster service at less cost.

Other programs that this system could complement would be the Immigration and Naturalization's I–9 Program. Through the use of Social Security numbers, TJTC screening could help with that program also, as well as the Jobs Training Partnership Act.

In the latter half of 1994, our home state of Illinois tested this system. This isn't some idea that we just kind of dreamed up. It has actually been used and was used very effectively out in the field.

A local employment staff could go to the field, take care of applicants much more quickly on their place or residence, and help the employers receive the tax credit, and provide a much quicker and better service than currently existed before.

We would hope that this program could be expanded to all States who are interested, and if not, the Department of Labor itself.

I thank you for inviting us today. I think it is a great forum to address these issues, and I look forward to your comments.

[The prepared statement follows:]

STATEMENT OF SCOTT D. SHIPMAN
SENIOR MANAGER, GOVERNMENT AFFAIRS DEPARTMENT
SHIPMAN, MAISON & ASSOCIATES, LTD.

Introduction

Thank you, Chairman Johnson. Madame Chairman, distinguished members of the committee, and honored guests, my name is Scott Shipman, Senior Manager-Government Affairs, for the firm of Shipman, Maison & Associates, Ltd. Our firm, based in Chicago, Illinois, is a tax/financial services firm.

Our firm, through its CEO, has been involved with the Targeted Jobs Tax Credit (TJTC) program since its creation in 1978, and while we support modification and extension of the program, we bring a unique perspective on *how* to more economically administer the TJTC program through the use of software technology. This, while simultaneously providing the state agencies with the ability to offer more services to their community.

Madame Chairman, our firm suggests modifying the administration of the TJTC program by the use of a software system, capable of fully administering a State or Federal TJTC program. This system has been tested on a pilot basis in our home state of Illinois. The system manages administration of the TJTC program faster, more efficiently, and more accurately, as it helps the state focus on servicing the applicant and employer communities at less cost to the taxpayer. We do not mean to suggest that the various states relish not being able to respond even faster, they don't, they merely lack the resources which limit their production and effectiveness. Essentially, a software system would do for the TJTC program that which ATM's have done for banking - provide faster service at less cost.

Specifically, this system manages the TJTC program by systematically organizing the TJTC process, starting with the state's ability to issue a certificate in less than 10 minutes, through *initiating* employer/community services rather than *reacting* to demands made upon them. This improvement in TJTC administration gives the local employment office the strength to serve its community, to more efficiently provide "employee pools" of TJTC qualified workers for job placement, consistent with the original intent of the TJTC legislation in 1978. This enhanced service increases employer participation in this and other programs offered by the local employment office, increasing the local office effectiveness and reducing the cost to operate same. For example, the system would complement the concept of the Department of Labor's "one-stop shopping" program, the Department of Naturalization and Immigration's I-9 administration, and the Jobs Training Partnership Act (JTPA). All with less staff than currently exists, resulting in less cost to the taxpayer.

The Illinois Department of Employment Security (IDES) has tested this software system on a pilot project basis, and on a more limited basis, by the state of California's Economic Development Department (EDD). In the areas where the software was used, IDES has been able, with less staff, to respond to employers needs by being able to more accurately and more efficiently process TJTC applicants and satisfy the information needs of the employers, while simultaneously reporting data to the Department of Labor (DOL). Additionally, DOL using existing forms from their ET Handbook 377 and the system we propose, would have accurate, statistical data totaled daily, and available for review and analysis. Again, the cost to the taxpayer would be far less than that which is currently in existence.

I would like to thank you for giving this program the attention it deserves, and for the opportunity to address these issues in this forum. Obviously the technology we suggest to modify the administration of the TJTC program is far more extensive than can be covered in the time allotted today. Accordingly, we have summarized our position in the text of our written testimony. I invite you to review our written testimony, as you may find it informative. Should you or the committee have any questions regarding my testimony, I would be more than happy to try to answer them at this time.

Overview

Essentially, in order to administer the TJTC program, a local employment office is responsible for the identification, verification and certification of an applicant, and "refer" the applicant to an employer for job placement. Our intent herein is to analyze each aspect of TJTC administration, and provide examples of comparing/contrasting local office activity with/against that which can be by utilizing software systems. The service aspect of administration is very important, as many office staffs are overburdened with current workload, hence, slow to respond to the needs of the community employer regarding TJTC certified applicants' jobs placement. With computer software, the exact opposite would be the creation of larger TJTC qualified "pools" - as was the design in 1978.

1.) Identification

The identification process is the first step in determining which applicants are eligible for TJTC certification. Eligibility determinations are made based on an applicant's membership in one of the nine targeted groups, generally: those receiving some sort of welfare or state aid, those who have been to vocational rehabilitation programs, those who have served in the military between 1964 and 1975, young adults between the ages of 18-23, years old, or are 16 or 17 years old at the time of hire, (summer youth category), those applicants convicted of a felony, or those applicants who are in a cooperative education program.

Currently, when an applicant visits a local employment office, the applicant must first complete a form, and "register" with that office before TJTC screening can begin. Naturally, completing forms, (all manually) and registration creates long lines with potentially slow service, and is subject to local custom.

Through the use of technology, software systems offer: on-line access to information, easy, and uniform targeted group identification, and standardization of service.

- o On-Line Access: Software can be linked with other state and federal agencies to provide comprehensive information.

- o Target Group Identification:
  All questions used to interview an applicant are on screen. A simple "Y" for "Yes" entry will identify the correct target group.

- o Standardization:
  The screening process eliminates pre-screening forms for the applicant to complete. Questions concerning the nine targeted categories are on the screen before the interviewing officer and are worded to standardize the entire interview hence not left subjectively to the interviewer.

Through the use of software, eligibility determination can be reached in two minutes or less, per applicant. Local offices not having software available take much longer.

2.) Verification

The second step of TJTC administration involves verification, i.e. the vouchering process. Verification means that once an applicant is identified as a member of a targeted group, the applicant must provide specific documentation evidencing eligibility in a particular target group.

Once the local office verifies that the documents prove that the person is a member of a targeted group, the office will issue a voucher for the applicant to take to an employer who has job openings. In return for hiring this vouchered applicant, upon certification, the employer may receive a tax credit. Currently, vouchers can take 30 minutes per

applicant to complete, and are often unreadable with carbon copy and/or sloppy handwriting. For those offices with TJTC software, computer data entry takes 1 minute or less, with legible results. Thus, service is greatly enhanced as applicants may now be referred to employer job openings by the local job service office. Since the software is mobile, it can be "loaded" on a notebook computer, or laptop, and set up at a job fair, or other on-site screening. Again, this service enhances local office involvement in the community.

3.) Certification

The third and final step in TJTC administration is the issuance of the certificate. This document evidences that the applicant is a member of a targeted group, and once this applicant has worked for an employer for the required period of time, the employer may take a tax credit of 40% of the first $6,000 of the members' qualified wages. At the local office level, the steps necessary to issue a certificate may take 15, 30, or 45 minutes or longer to complete, whereas with a software system, certification is issued at the touch of a button.

The local office address, applicant address, date, social security number, etc. is automatically recorded and stored as a result of the initial screening or registering process. The local office official needs to sign and date the certificate, then mail it to the employer. Again, because the system is mobile, the software may be set up anywhere there is an electrical outlet, and the local office will be in service. This entire process from registration to certification is done in less than 10 minutes, and there is no duplication of data entry upon return to the office.

4.) Reporting

All local employment offices need to report TJTC activity to a central state office, for monitoring, and reporting to regional and DOL offices. At the local office level, it currently takes *hours* to compile the quarterly report and includes running the risk of errors which require additional hours to reconcile. Each level of "roll-up" again requires innumerable hours to compile. Utilizing software, the entire quarterly data is accurately compiled *daily* and reported, with the touch of a button.

Real world examples drive the need for a software system. Many employers or employer representatives call the local and state employment offices to inquire about the status of a person sent in for TJTC determination, or call about the status of the certification. This checking is extremely time consuming for the local office, particularly if the request is (as often the case) more than 2 years old. Because of the volume, the local office staff person has to stop current processing, and manually retrieve stored files to find the information. Some states have to shut down the entire process when conducting status searches. Hence, quite naturally, the states are reluctant to perform the search until a more opportune time, thus creating additional bottlenecks and more employer questions. With the software system, a simple entry of the applicants' social security number would retrieve the answer immediately.

Recently, a local employment office had two opportunities to use the software system. In one instance an employer inquired as to the number of individuals the office had interviewed, and of those interviewed, the number of those individuals determined to be TJTC eligible. The local office was able to give this employer complete reports, by target group, in less than 5 minutes. By contrast, a local office had three employment officers servicing applicants manually, while another officer used the software system. At the end of the day, each officer reported totals. The three officers who serviced applicants manually were still accumulating totals, while the officer with the software was finished, had accurate data, with no need to reconcile errors.

Additionally, officers utilizing a manual process have to return to their office, prepare and record the appropriate vouchers and mail them to the employer for the appropriate employer signature, receive the vouchers in return from the employer then prepare certificates and mail to the employer. Officers utilizing software may issue vouchers and certificates on site, thus permitting the employer to allow the eligible employee to go to work not needing to return to the local job service office for additional information. This simple step encourages local participation by the employer of other state services and programs.

Comparison: Manual Versus Software TJTC Administration

To review, basic TJTC administration involves identifying who is eligible for the program, verification as to being a member of a target group, and certifying the individual for the employer. The following is a chart contrasting the speed, accuracy, and ability of the current local employment office (manual) procedure versus a software based system:

Identification

Manual	Software
Screening: 5-10 Minutes	2 Minutes or Less
Register: By Paper	Electronically
Other Data: Calling other Agencies	Database
Questions: Subjective, by locale	Objective

Verification

Application: Paper, with Carbon Copies	Electronically
Time: 10-30 minutes by hand	1-3 minutes
Accuracy: Varies, by locale	Objective

Certification

Application: By Paper, Typed	Electronically
Time: 15, 30, 45 Minutes or more	Seconds
Accuracy: Variable	Total

TJTC federal funding is proportional to the number of certificates issued. The funds received for the TJTC program does not cover the full cost necessary to administer the program. Therefore, time is taken away from other employment security office duties, including job placement. By computerizing the TJTC process, the local office could consider scheduling opportunities to address other areas of responsibility and possibly provide even more service to the local community such as job placement "pools", hence, once more, getting back to the original intent of the TJTC program.

Conclusion

Our testimony will close with some recommendations and a final thought regarding the TJTC program.

To Modify The TJTC Program:

- o Extend the program for at least 6 years.
- o Offer a credit for 2 years - 25% first year, then 75% second year, to encourage retention.
- o Set the minimum salary to qualify at $6 per hour.
- o Reinstate 23 and 24 year olds as a targeted group.
- o Make all veterans an eligible target group.
- o Add a targeted group to include those over 55 years old.
- o Add a targeted group to include those who have exhausted unemployment insurance benefits.
- o Eliminate the Letter of Request, and issue certificates for individuals hired through the State Employment Service Agency (SESA).
- o Allocate funding for automation.
- o Increase funding for advertising the program. Comments from employers who have "heard something" about the program still leaves a lot to be desired.

The TJTC program has provided an incentive for employers to hire the disadvantaged. While modifications are necessary and appropriate to enhance the program, administration of the program needs to be improved. Current technology is available to help assist the local office in providing a complete service to the community so that all who seek jobs will be referred to an employer who has openings. Through software, the local office will be able to reassert its position in the community, rather than be just the alternative for those seeking employment. A software system would benefit the employer, the applicant, and the local office by saving each of these entities time - of which, in the business world, there is never enough.

Chairman JOHNSON. Thank you.

One way to crystalize this issue, perhaps, since this is the last panel that will testify on the targeted jobs tax credit is, is it more efficient, more effective, and fairer to provide the benefit to the employer, to hire this kind of applicant, and presumably provide the support and training that they need?

Is it fairer to that applicant, and better policy, to provide a skill grant or a training grant so that they can develop the needed skills or learn proper on-the-job work habits, giving them a better choice of employers?

Really, in this group, it is not a question of whether we subsidize this group or not. We really understand that we have to subsidize this group.

The question is, do you do it more effectively by providing the employer a break, or by, in a sense, bringing that person into the general job training, skill development program, that States make available? Briefly, because we do have several more panels, could you comment briefly on that larger issue.

I can see a lot of work has gone into the restructuring proposal. I would just point out to you, Mr. Hubbard, that the eligibility criteria, at least in this brief summary, says veterans who are either currently receiving or have received public assistance in the 18 months prior to hire.

Mr. HUBBARD. That is correct.

Chairman JOHNSON. It is a very limited focus on very low-income veterans?

Mr. HUBBARD. That is correct.

Chairman JOHNSON. OK. Thank you. I just wanted to be sure you were aware of that.

Mr. HUBBARD. That is correct. With respect to training grants as opposed to subsidizing an employer, I agree with the previous comment, that business does it better.

Business is in a much better position to know exactly what kinds of skills they need, then to recruit people and train them in those skills.

Chairman JOHNSON. Thank you.

I yield to Mr. Portman.

Mr. PORTMAN. I thank the Chairwoman. I assume you heard the dialog from the previous panel, and that you might suspect I have some of the same questions for you all.

First of all, thank you for being here and sharing your insights with us.

I would say in response to Ms. Oven saying that—I think your quote was, "this is a perfect fit with regard to welfare to work." I would disagree with that.

I think it is not a perfect fit, when you have, again, the kind of evidence that I have seen, whether it is the GAO report, the Inspector General's report, the other Department of Labor report, or my own, again, companies back home, who give me anecdotal evidence, which indicates that they would have hired many of these people anyway.

The fact is that many employers—and that probably is not true with regard to Ms. Oven's company or the other companies of people represented here. I would say that from what I know of it—and

I am trying to find out more—that most employers, in fact, who are participating in this program, or at least most of the employees, are hired, as any other employee would be hired, to fill an entry position.

Then, after the employee is hired, to determine whether that employee fits the criteria set forth under the tax credit. If they then fit, the employer can qualify for the tax credit and apply for it.

That seems to me to be quite strong evidence of the fact that these people would have been hired anyway.

And again, I think the Houghton proposal is a leap forward. I think it has some problems with it, but I think we need to target more precisely—if we are doing a welfare-to-work program, let's target those people who are on public assistance.

Why provide, according to the Department of Labor, 92 percent of this subsidy to people who would have been hired anyway, and only 8 percent to those who would not have been? Given the scarce Federal dollars, we have got to be more cost effective, we have got to be more targeted.

I would say to Mr. Hubbard's comments, I agree with you, and I think the Houghton approach does a pretty good job.

It is not just Vietnam-era veterans, incidentally. It also would apply to other veterans. I think that is a good example of a way to target the program more precisely to the problem.

I look forward to working with the panel members. You know much more about this program than I and others who have been involved in it do. You have had good experiences figuring out ways to target the program more precisely to the problem, and not be satisfied with the status quo.

Any comments, Ms. Oven, as to your experience, or how we might target it better with regard to precertification, or other ideas?

Ms. OVEN. Yes, I would be glad to comment.

I am not sure if you are aware, that in order for us to comply with EEO requirements, there are many of the TJTC category questions from the old program that we are not legally permitted to ask until a job offer has been made.

That really limits an employer's ability to know, for sure, whether or not we are hiring a TJTC candidate. About the only way we can know for sure is if we go to a community agency, a United Way agency or something like that, and recruit candidates, which our company does.

Even then, for example, if we recruit from an agency that places persons with disabilities, we can ask that they refer TJTC candidates to us. That is not a guarantee. Our screening for candidates is done after the offer is made to comply with EEO, equal employment opportunity, requirements.

With the new proposal, that issue needs to be addressed as a part of that, because we are talking about protected classes, and no company's legal department is going to let them ask those questions, and take that kind of risk, in violation of the EEOC, Equal Employment Opportunity Commission.

Mr. PORTMAN. I understand the problem, and I think there would need to be some sort of a safe harbor provision, or some way to be sure that people felt comfortable.

I hear from employers, beyond that, that even in areas that might be considered safe under existing EEO law, they are afraid of the possibility of litigation, even if groundless, would then cost them enormous amounts in terms of defending themselves.

They are just not willing to get into it at all, and they would rather just wait and see whether the criteria are met after the fact. But again, that gets to the problem, as I see it with the current program, which is that we are not targeting those dollars as precisely as we should.

Mr. Hubbard, do you have a comment?

Mr. HUBBARD. Yes, Mr. Portman, I do.

With regard to these people being hired anyway, if that were the case, I do not think that the unemployment rate for male veterans between 20 and 35 would be as high as 11.8 percent.

A good many of these people are veterans of the armed forces, who served in the combat arms, who do not have skills that are applicable to the job market, except perhaps for some things about initiative and the work ethic, and those kind of things which they learn in the military.

There is another issue here which these people face, and that is one of certification in some cases. For example, a medic who treated gunshot wounds in the Persian Gulf cannot get a job in Washington, DC, without going back to school, just to treat gunshot wounds. That is another whole issue that we are actively involved in with the Department of Labor.

Veterans do face some rather major hurdles out there, and I am not convinced that employers would hire them anyway, were it not for TJTC.

Mr. PORTMAN. That is a good observation. I think it is, frankly, a further argument for further targeting of the existing program.

Mr. HUBBARD. Perhaps.

Mr. PORTMAN. Mr. Shipman, any comments on our colloquy here?

Mr. SHIPMAN. Congressman, the burden on the States to help process this program is significant. Funding keeps getting cut, and staffs keep getting cut every year.

The lack of continuous legislation is a very big pain to them. They, just as businesses cannot plan, neither can the States.

They need a strong signal, and a financial signal, from this body, on which way this program is going.

It is very hard to take care of applicants when their is no way to provide for them otherwise.

Mr. PORTMAN. That is a good point. I think it holds true for the private sector as well, as you indicate. We need to make this permanent, I believe, or disband it and try something new, and I do not like the idea of the temporary extensions.

I would just ask one more question, I think we have another panel ready to go, and that is, with regard to the screening we talked about, Ms. Oven, assuming we could have some sort of EEO safeguards, do you see a concern with self-certification? In other words, if we do not have documentation from a public assistance agency, or as you indicate, from a United Way agency, and so on, how do we deal with the self-certification matter?

Do you have any thoughts on that? This is really an administrative question, administration of the program. But I see that as one

of the potential problems with the reform that we are talking about.

Ms. OVEN. My understanding is that the new program has identified objective criteria for the proposed categories.

I am not sure that the new program has a self-certification provision. You mean the employees themselves come and say they are TJTC-eligible? I am not aware of what provision the new proposal has for the employee, potential employee to know, unless they are working with an agency such as the United Way agency, that informs them of that.

Mr. PORTMAN. Mr. Hubbard.

Mr. HUBBARD. I do not think the vast majority of people who are eligible for TJTC even know what it means.

Mr. SHIPMAN. Let me just comment further with regard to veterans. There would be a way to certify that that individual qualified, assuming that was one of the criteria as it is in the Houghton approach.

Mr. HUBBARD. People who leave the armed forces these days attend something called Transition Assistance Program. It is run by the Veterans Employment and Training Service at the Department of Labor. In that program, they are told to visit the office at the State employment security agency when they get back home and get ready to look for a job.

The counselors in the State employment security agencies are aware of TJTC. If it comes back into being again, they will begin to ask these people to determine whether they are eligible for TJTC. The system exists.

Mr. SHIPMAN. Congressman, if I may, in the State of Illinois, using a software system, you would have objective criteria throughout the State.

If someone discharging from the military moves back to their hometown and it would be St. Louis on the Illinois side, the questions asked of them, in east St. Louis while they were in Chicago, would be exactly the same. That way you don't have variances by local custom or by State. It would be flat.

Mr. PORTMAN. That is a good point.

I thank you all very much for your testimony and for coming today to give us some insights.

I would now like to call my distinguished colleague from Indiana, Mr. Jacobs.

Mr. JACOBS. Thank you, Mr. Chairman.

I would rather be a neighbor than a colleague, actually, Ohio and Indiana.

Mr. PORTMAN. Well, you are both.

Mr. JACOBS. Thank you.

Mr. PORTMAN. Doubly blessed.

Mr. JACOBS. I appreciate that.

I have come to testify in favor of the bills, H.R. 733 and 734, gifts of appreciated property, and the scheme of it is quite simple. We want to encourage charitable giving, and we can do so by allowing donors to deduct the current market value of the gift to worthy causes.

The law expired or, rather, sunsetted at the beginning of this year, and its effect has been so salutary that it seems logical that it should be extended not only in time, but also in description.

Rather than stock alone, let us say you have a piece of property that might be useful for a foundation to help children or something like that. It has appreciated in value. You could either keep it and let it pass through your estate with, in most cases, no tax incident, or you could make the gift to the foundation and the government would not collect tax on the appreciation, but on the other hand, the government never would have got the tax, anyway. Cost is roughly $57 million per year, and obviously, I think it is in the public interest to work very well.

Here is the surprise of the day. That is it.

Mr. PORTMAN. I thank my neighbor, as well as a colleague.

I have to recuse myself here perhaps. My wife was at one time an employee of a private foundation which suffered under not knowing whether these extensions would occur, and I would tend to be quite biased in favor of your proposal.

Let me ask you a couple of questions, though, with regard to how this might work. As a general rule, right now to other 501(c)(3)s, it is my understanding that you do get the market value and not the cost basis, but with regard to private foundations, there is a distinction. Is that correct?

Mr. JACOBS. I am sorry, Rob. I didn't quite—

Mr. PORTMAN. With regard to a contribution to a 501(c)(3), say, a social service agency or some other charitable gift, you would be permitted to get the market value of your publicly traded stock as compared to your cost basis.

Mr. JACOBS. Yes, that is correct, and that has been the law for some time. Unfortunately, it was set up in a way that it would sunset.

I don't know of any serious complaints about it. It has worked pretty well.

Mr. PORTMAN. Let me ask you if you know what percentage of gifts to private foundations are now made in the form of publicly traded stocks. Do you have any sense of that?

Mr. JACOBS. The answer to your question is not complicated. No, I do not know.

Mr. PORTMAN. OK.

Mr. JACOBS. I know that, generally, when the law was not in effect, there was a serious diminution of contributions, and when it was reenacted or enacted, there was an increase, but I can't tell you exactly what percentage that is.

By the way, I should say that Mr. Camp is my cosponsor or I am his cosponsor. We are partners in this thing.

Mr. PORTMAN. You would be full partners.

With that, I will return to the Chairwoman to ask you further penetrating questions.

Mr. JACOBS. Good for you. Don't you love it how people dance all over the lot, "Madam Chair," this and that?

Mr. PORTMAN. I never know whether to call her "Chair," "Chairwoman," or "Madam Chair."

Mr. JACOBS. If it is "Mr. Chairman," why isn't it "Ms. Chairwoman"? Did we ask that today?

By the way, may I say one other thing? My sister used to say when people addressed her as "Madam," generally solicitors, and salespeople, she would always say—and I haven't the slightest idea what this meant, but she would always say, "Don't call me 'Madam.' I just work here." Now, I don't know what that meant.

Chairman JOHNSON. Dave Camp did testify earlier and mentioned that you were in this together, and we do appreciate that bipartisan support, frankly, that is a very important little provision that we do have to consider, thank you for your testimony.

Mr. JACOBS. Thank you, and I appreciate the indulgence of the Committee, even for the dull humor.

Chairman JOHNSON. The next panel is Willie Brown, medical records clerk of the Hampton VA Hospital; Paul Speranza, the secretary and general counsel of Wegmans Food Markets, Rochester, New York; and Frederick Hunt, president of the Society of Professional Benefits Administrators, on behalf of the American Society of Association Executives.

We will start with Mr. Brown, and you will observe the lights, if you please, as we have two more rather long panels after this.

STATEMENT OF WILLIE BROWN, MEDICAL RECORDS CLERK, HAMPTON VETERANS ADMINISTRATION HOSPITAL, HAMPTON, VIRGINIA; ON BEHALF OF THE SECTION 127 COALITION

Mr. BROWN. Good afternoon, Madam Chairwoman and Members of the Subcommittee.

I am pleased to testify on behalf of the Section 127 Coalition in support of the permanent extension of section 127 of the IRC, Internal Revenue Code.

The Section 127 Coalition is a diverse group of businesses and their associations, labor organizations, educational institutions, and human resource experts that are committed to making section 127 a permanent part of the Tax Code.

My name is Willie Brown, and I am a medical records clerk at the Hampton Veterans Administration Hospital in Hampton, Virginia. In addition, I am also a student at Thomas Nelson Community College, also in Hampton.

Quite simply, section 127 is what makes my education possible. I support a family. I am married and have three children. Section 127 allows me to receive up to $5,250 a year in tax-free reimbursements from my employer for tuition, books, and fees for education and training that is not job related.

I am nearing the completion of my associate's degree in public administration, and I hope to continue my education at Christopher Newport University in Newport News, Virginia.

Many of my courses are not purely related to my current job. If I had to pay Federal, State, and local taxes on this benefit out of my pocket, I just couldn't do it.

As president of the Thomas Nelson Community College Student Council, I know that many students are in the same position. Indeed, many are economically disadvantaged. Students have had to stop taking classes when section 127 has expired from time to time. They simply cannot afford to see their already small paychecks further reduced by the tax they would have to pay if they take these

classes, and I understand that this Committee is considering whether or not section 127 should be made a permanent part of the Tax Code.

In reading the history of this issue, it appears that this Committee and Congress originally enacted section 127 for several reasons. Specifically, according to the explanation of the 1978 bill, section 127 was passed because prior law gave rise to an inequitable administration. In addition to the complexity of the tax system, it may have acted as a disintentive to continuing education, particularly among those at the lower end of the economic scale, and those same reasons, they still exist today.

I see much in the news these days about efforts to get the IRS out of citizens' lives. Section 127 does just that by eliminating bureaucratic questionings about whether a class is job related or not. More importantly, section 127 promotes upward mobility among the work force. Yet, it is largely funded by employers, not the Federal Government. Employers provide these benefits to their employees because they see a return on the investment of the employee's education. With additional training and education, these same employees will be able to take on more complex tasks and assume more responsibility. At the same time, numerous studies have shown that education continues to be the ticket to higher earnings.

According to the Bureau of Census, the mean annual earnings of a high school graduate is $18,737. For those with an associate's degree, the mean annual earnings rise to $24,398. College graduates have a mean annual earnings of $32,629. In essence, by enabling employers to provide tax-excludable education to relatively low-paid workers, Congress is ensuring that these workers will use that education to do better work, increase their salaries, and pay higher taxes.

Making section 127 permanent would mean that the Federal Government is encouraging upward mobility. Indeed, you will be promoting a higher standard of living and making work more rewarding by permanently extending section 127.

I would also note that there are even more compelling reasons to make section 127 permanent now than there were when the law was first changed in 1978.

Today, workers change jobs more frequently. There is more international competition, and rapidly changing technology requires a more-skilled and a more regularly trained work force.

Last, as you may know, Coopers & Lybrand completed a study in 1989 of Federal data to determine the characteristics of the beneficiaries of section 127. In that study, nearly 99 percent of section 127 recipients earned less than $50,000. Seventy-one-percent earned less than $30,000, and 36 percent less than $20,000.

Several weeks ago, the Department of Education released the data necessary to bring the study up to date. That update is underway, and a revised study will be provided to this Committee as soon as it is complete.

Madam Chairwoman, I am appreciative of the opportunity to testify before you on this matter.

Chairman JOHNSON. Thank you, Mr. Brown. Your testimony is very helpful.

I would like to recognize Mr. Speranza now.

STATEMENT OF PAUL S. SPERANZA, JR., CORPORATE SECRETARY AND GENERAL COUNSEL, WEGMANS FOOD MARKETS, INC., ROCHESTER, NEW YORK

Mr. SPERANZA. Thank you.

Good afternoon. I am Paul Speranza, and I am corporate secretary and general counsel for Wegmans Food Markets, Inc., which is headquartered in Rochester, New York.

I want to thank you, Congresswoman Johnson, Members of the Subcommittee, and staff for the opportunity to speak to you today on behalf of Wegmans.

Because of our extremely positive experience with the Wegmans scholarship program, we strongly urge you to permanently extend the exclusion for employer-provided educational assistance, pursuant to IRC section 127, through the bill presently before Congress, submitted by Congressman Levin on January 4 of this year. That is entitled Employee Educational Assistance Act of 1995, which, coincidentally, is H.R. 127 or through any other appropriate legislative vehicle.

Wegmans employee scholars have been taking advantage of section 127 since 1984. Since the Wegmans scholarship program began in 1984, Wegmans has awarded over $25 million in scholarships to over 7,200 employees.

Wegmans spent $4 million in 1994 on 2,230 current employee scholarship holders, and Wegmans plans to add another 700 new scholarship recipients in 1995.

Wegmans receives a tax deduction for these expenditures whether they are considered compensation to the scholarship recipient or a scholarship benefit under section 127. Hence, our concern is purely for the financial welfare or our employees and others similarly situated throughout the United States.

Scholarships are awarded to employees who demonstrate excellent work performance, above-average academic achievement, and these two factors account for 50 percent of the decision to award a scholarship. The specifics of the program are set forth in my written testimony.

Section 127 helps people help themselves. Beneficiaries of section 127 are better educated. Hence, they can help themselves. Once educated, these people will have substantially greater earning power and, therefore, pay higher taxes of all kinds, income tax, property tax, sales taxes, and so forth, throughout their lives which will more than offset the tax exemption received under section 127.

Further, making the exclusion permanent is critically important. Parents and college students are on extremely tight budgets. Without a permanent exclusion, they can't financially plan. This exclusion has been extended numerous times, making the administration of a scholarship program extremely difficult.

Trying to explain to over 2,000 families why the dollars they thought they had are no longer there is very difficult. Explaining how to apply for a refund after the fact is also very difficult; for example, 6 pages of forms and instructions as to how to go about doing that. This leaves a very negative impression of our representatives in Washington.

Wegmans has always placed a premium on education at all levels. This scholarship program is just one of several programs it

sponsors through large donations of money, and the donations of money and time of many of its employees. These programs are key elements of Wegmans' success.

Wegmans employs approximately 24,000 individuals. According to the New York State Department of Labor, it is listed as one of the top 10 private employers in New York State.

In a front-page article in The Wall Street Journal on December 27, 1994, which favorably described Wegmans, one nationally renowned industry expert stated, "We consider them," meaning Wegmans, "the best chain in the country, maybe the world."

The television show "Wall Street Week" did a followup piece on its weekly national television show which featured a Wegmans scholarship winner describing the importance of his scholarship. He stated that he could not afford a private education without Wegmans' help.

Wegmans has always been in the forefront of providing top wages, benefits, and working conditions for its employees and has been nationally recognized for its efforts. Some of Wegmans' honors include being named by Fortune magazine as the best supermarket retailer in America in serving its customers.

Being included in the recently published book entitled "The 100 Best Companies to Work for in America."

Being recognized by Working Mother magazine for the fifth consecutive year as one of the best 100 companies for working mothers in America.

Receiving a Point of Light Award by President Bush for having the best corporate charitable program in America, the Work Scholarship Connection Program assists economically disadvantaged youth; being named the top produce retailer and top deli trendsetter, and being recognized as having the best video departments in America by various industry publications.

Section 127 has been an integral part of many of Wegmans' success stories. Wegmans is successful because of its motivated and educated work force. If Wegmans can do this, so can others.

A permanent exclusion for employer-provided educational assistance makes it much easier for all American businesses to educate its employees. It is only through education that Americans can maintain and improve its status in the world economic community.

Thank you.

[The prepared statement follows:]

PAUL S. SPERANZA, JR. ON BEHALF
OF
WEGMANS FOOD MARKETS, INC.

May 9, 1995 Subcommittee on Oversight Hearing of the Committee on Ways and Means - Exclusion for Employer-Provided Educational Assistance (Code Section 127)

Good afternoon, I am Paul Speranza. I am Corporate Secretary and General Counsel for Wegmans Food Markets, Inc. which has its headquarters in Rochester, New York. I want to thank you Congresswoman Johnson, members of this Subcommittee and staff for the opportunity to speak to you today on behalf of Wegmans Food Markets, Inc. Because of our extremely positive experience with the Wegmans Scholarship Program, we strongly urge you to permanently extend the Exclusion for Employer-Provided Educational Assistance pursuant to Internal Revenue Code Section 127 through the bill presently before Congress submitted by Congressman Levin on January 4, 1995 entitled "Employer Educational Assistance Act of 1995" which coincidentally is HR 127 or through any other appropriate legislative vehicle.

Wegmans Food Markets, Inc. employee scholars have taken advantage of Section 127 since 1984. Since the Wegmans Scholarship Program began in 1984, Wegmans has awarded over $25,000,000 in scholarships to over 7,200 employees. Wegmans spent $4,000,000 in 1994 on 2,230 current employee scholarship holders, and Wegmans plans to add another 700 new scholarship recipients in 1995. The program pays 50% of tuition up to a maximum of $1,500 per academic year. Wegmans receives a tax deduction for these expenditures whether they are considered compensation to the scholarship recipient or a scholarship benefit under Section 127, hence, our concern is purely for the financial welfare of our employees and others similarly situated throughout the United States. To be eligible, employees must be continuously employed for at least 21 months by the time they plan to use the award and they must work an average of ten hours per week. Scholarships are awarded to employees who demonstrate excellent work performance, above average academic achievement, and these two factors account for 50% each of the decision to award a scholarship. There are no restrictions on fields of study. Winners are required to work 300 hours per year to be eligible to renew their awards and scholarships are renewable for up to a total award of four years. Winners must continue to demonstrate excellent work performance, and they are reviewed annually by their supervisors. An independent agency judges the academic portion of the scholarship application by using a committee made up of varied experts in the field of education. A committee of store managers judges the work performance portion of the scholarship application based on performance appraisals submitted by the applicant's department manager and store manager.

Internal Revenue Code Section 127 helps people help themselves. Beneficiaries of Section 127 are better educated, hence they help themselves. Once educated, these people will have substantially greater earning power and therefore, pay higher taxes of all kinds (income, real property, sales, etc.) throughout their lives which will more than offset the tax exemption received under Section 127. Further, making the exclusion permanent is critically important. Parents and college students are on extremely tight budgets. Without a permanent exclusion, they cannot financially plan. This exclusion has been extended numerous times, making the administration of a scholarship program extremely difficult. Trying to explain to over 2,000 families why the dollars they thought they had are no longer there is very difficult. Explaining how to apply for a refund after the fact is also very difficult. This leaves a very negative impression of our representatives in Washington.

Wegmans Food Markets, Inc. has always placed a premium on education at all levels. This scholarship program is just one of several programs it sponsors through large donations of money and the donations of money and time of many of its employees. These programs are key elements of Wegmans' success. Wegmans Food Markets, Inc. employs approximately 24,000 individuals. According to the New York State Department of Labor, it is listed as one of Top Ten Private Employers in New York State. In a front page article in The Wall Street Journal on December 27, 1994 which favorably described Wegmans, one nationally renowned industry expert stated, "We consider them (Wegmans) the best chain in the country, maybe the world." The television show "Wall Street Week" did a follow-up piece on its weekly national television show, which featured a Wegmans' scholarship winner describing the importance of his Wegmans Scholarship. He stated that he could not afford a private college education without Wegmans' help. Wegmans has always been in the forefront of providing top wages, benefits, and working conditions for its employees and has been nationally recognized for its efforts. Some of Wegmans' honors include being named by Fortune magazine as the Best Supermarket Retailer in America in serving its customers, being included in a recently published book entitled, The 100 Best Companies to Work for in America, being recognized by Working Mother magazine for the fifth consecutive year as one of the Best 100 Companies for Working Mothers in America, receiving a Point of Light award by President Bush for having the Best Corporate Charitable Program in America (the Work Scholarship Connection Program assists economically disadvantaged youth), being named the Top Produce Retailer and Top Deli Trendsetter, and being recognized as having the Best Video Department in America by various industry publications. Section 127 of the Internal Revenue Code has been an integral part of many of Wegmans' success stories. Wegmans is successful because of its motivated and educated work force. If Wegmans can do this, so can others. A permanent exclusion for employer-provided educational assistance makes it much easier for all American businesses to educate its employees. It is only through education that America can maintain and improve its status in the world economic community.

Chairman JOHNSON. Thank you, Mr. Speranza.
Mr. Hunt.

STATEMENT BY FREDERICK D. HUNT, JR., PRESIDENT, SOCIETY OF PROFESSIONAL BENEFITS ADMINISTRATORS; ON BEHALF OF AMERICAN SOCIETY OF ASSOCIATION EXECUTIVES

Mr. HUNT. Good afternoon. My name is Fred Hunt. I am president of the Society of Professional Benefits Administrators, but today I am speaking for an even larger constituency, and that is the ASAE, American Society of Association Executives, where I have served as a volunteer on the government affairs and the insurance industry committees.

ASAE is a not-for-profit, tax-exempt, umbrella organization, organized to serve and represent association executives such as myself. ASAE's membership includes about 22,300 association executives as well as suppliers of goods and services to the association community. Approximately one-third of ASAE's association executives manage charitable and philanthropic organizations. The remaining two-thirds manage professional societies and trade associations.

The more than 10,400 associations, including many that you have heard from today in this room, are managed by ASAE members which include international, national, regional, State, and local associations, as well as multitiered federations. At one point, we added up to see what is the constituency, and we discovered it was about 287 million people, which is pretty good. It obviously shows that there is overlap in this country, but it shows that almost every American gets touched by the association community.

Let me add, parenthetically, that this is really a threefold testimony. You are really getting three different perspectives.

Most association executives such as myself are employees, and thus, we can tell you from an employee point of view in a field where continuing education and new fields is very important. Most of us are employers. We employ people, and so we know what we are looking for, what we want to hire.

Third, associations, much like yourselves, end up being clearinghouses. When people have complaints, when there are trends, when there are needs, they come to us, just as you have heard most of the testimony today. It has been on behalf of associations.

Please look at this as really three testimonies in one. Fortunately, they all three agree.

ASAE is testifying today on behalf of the many organizations it represents, virtually all of whom have a keen interest in the reinstatement and continuation on a permanent basis of IRC section 127.

As such, ASAE strongly urges Congress to permanently extend section 127 of the IRC providing an exclusion from income for the value of the employer-provided education assistance.

As you know, the important provision expired on December 31, 1994, and with it went the hopes of many middle class and, I would say also, senior executives. Many industries are changing today, as well as, of course, the lower income. This is an across-the-scale issue.

Associations and other employers will also suffer if this provision is not extended. They use section 127 as a valuable retraining tool within their industries for workers who lose jobs or whose jobs have become obsolete. In short, section 127 helps associations, businesses, and workers develop the skills they need to compete in today's changing global economy.

Specifically, section 127 allows employers, including associations, to provide up to $5,250 per year to each of their employees in tax-free reimbursements for tuition, books, and fees that are not directly related to their job.

Congress has continually affirmed its support for this program since its inception in 1978. Since then, more than 7 million Americans have been able to work and attend classes in order to improve their skills and quality for better jobs. These individuals are from large, medium, and small associations, companies, and other employers throughout the country.

The section 127 program is the only way that many millions of working men and women can contribute to further their education while they perform their responsibilities to their families, employers, and hold down their jobs.

Continuing education is a vital factor in the growth and promotion of America's work force, and I would say you have heard a number of good things; to summarize, seeing the light.

Mr. Portman had a good point that these things pay, and I think you should look at this section 127 as a revenue raiser. This is going to generate money. You have heard all three of us mention there is a direct correlation. More education means more income which means more income taxes, and for that $5,250 that somebody may get, they may learn how to use a computer. They may learn how to get a college degree, whatever it may be. These are the things that will allow them to go up, and we have spent lots of money, certainly, throughout saying education means better jobs. I think this is a revenue raiser. It is an investment rather than an expense.

The ASAE thanks you very much, and I hope you will look at the written record for more thorough recommendations that we have to offer today.

[The prepared statement follows:]

STATEMENT OF FREDERICK D. HUNT, JR.
ON BEHALF OF
THE AMERICAN SOCIETY OF ASSOCIATION EXECUTIVES (ASAE)

Good afternoon. My name is Frederick D. Hunt, Jr. and I am President of the Society of Professional Benefits Administrators (SPBA). I am testifying this afternoon on behalf of the American Society of Association Executives (ASAE), where I serve as a volunteer on the ASAE Government Affairs Committee.

ASAE is a not-for-profit, tax-exempt, umbrella organization organized to serve and represent association executives. ASAE's membership includes approximately 22,300 association executives, as well as suppliers of goods and services to the association community.

Approximately one-third of ASAE's association executives manage charitable and philanthropic organizations; the remaining two-thirds manage professional societies and trade associations. The more than 10,400 associations managed by ASAE members include international, national, regional, state, and local associations, as well as multi-tiered federations and coalitions.

If you count up the memberships of all organizations which have representation in ASAE, more than 287 million individuals, companies, churches, universities, and other types of groups are represented. Of course, this figure includes many duplications, since many individuals and companies belong to more than just one association — but it illustrates the magnitude of how Associations Advance America.

ASAE is testifying today on behalf of the many organizations it represents, virtually all of whom have a keen interest in the reinstatement — and continuation on a permanent basis — of IRC Section 127. As such, ASAE strongly urges Congress to permanently extend section 127 of the *Internal Revenue Code*, providing an exclusion from income for the value of employer-provided education assistance.

As you know, this important provision expired on December 31, 1994. With it went the hopes of thousands of middle-class employees who use these benefits to attend school and further their education.

Associations, businesses and other employers will also suffer if this provision is not extended; they use section 127 as a valuable retraining tool for workers whose jobs have become obsolete. In short, section 127 helps associations, businesses and workers develop the skills needed to compete in today's changing global economy.

Specifically, section 127 allows employers, including associations, to provide up to $5,250 per year to each of their employees in tax-free reimbursements for tuition, books and fees for non-job-related education.

Congress has continually affirmed its support for this program since its inception in 1978. Since then, more than seven million Americans have been able to work and attend classes in order to improve their skills and qualify for better jobs. These individuals are from large, medium and small associations, companies and other employers throughout the country. The section 127 program is the only way that many millions of working men and women can continue to further their education while they perform their responsibilities to their

families and employers, hold down their jobs, and enhance their own skills for the constantly changing workplace.

Continuing education is a vital factor in the growth and promotion of America's workforce. It enables individuals to broaden their skills and knowledge and keep pace with changing technology.

Government statistics tell us that the majority of U.S. workers now have less than four years of high school, yet nearly two-thirds of all new jobs in our economy will soon require more than a high school education. America must deal with this problem quickly. And one means of answering this dilemma is to provide an incentive to individuals and employers to making a permanent commitment to life-long education.

Section 127 education assistance benefits are a prudent and economically sound investment in the American workforce. Nobody can disagree that continuing education and training of the U.S. worker are fundamental to meeting the challenges of the global economy, and enabling our nation to compete effectively against formidable competition.

Why should America's associations be so concerned about Section 127 extension? Because we are both employers as well as "servants" of our own memberships, i.e., the myriad of trade and professional organizations which rely upon the educational infrastructure as the backbone of our economic health and progress.

Virtually all associations have a vital stake in insuring that our members — whether they are individuals, corporations, universities, or other types of organizations — are able to continuously educate their employees in their own unique ways.

According to the key study entitled ***The Value of Associations to American Society,*** jointly conducted by the Hudson Institute, the American Society of Association Executives, and the ASAE Foundation, associations are now more deeply immersed in education than in any other activity, save conventions. Even this statistic may be slightly misleading, since most conventions and trade shows are directly related to educational programming and product and technical displays which keep entire industries and professions educated about new goods and services.

Some other reasons for ASAE's strong support of Section 127:

- Association members spend nearly $5.5 billion annually to fund their own employee and member educational needs and to organize or facilitate industry-specific educational programming.

- According to ASAE's estimates, nearly 90% of associations now offer educational programs and services to members.

- Education-based associations serve the public by improving the technical skills as well as the leadership and management abilities of both members and non-members.

- A very special place for association education is found in translating general discoveries and principles into the concrete requirements of particular industries and professions. This

capacity places association in a leading role to train and retrain the future workforce, and to advance society's needs.

- Association education serves the interests of members by increasing their productivity, enabling them to meet requirements for continuing education, helping to define their profession, and providing an important source of revenue. The public interest is directly related to this self-interest of specific industry and professional groups.

In closing, Mr. Chairman, employee education assistance has been repeatedly embraced by Congress and a majority of U.S. employers as one of the country's proven "competitiveness" policies. And this policy is all about empowerment, private sector initiative, and marketplace dynamics. It is time to make the ***Employee Educational Assistance Act*** permanent law.

Thank you.

Chairman JOHNSON. Thank you very much.

One of the things that you have heard in this hearing is that every extender that we adopt has to be paid for. One of the things that interests me is the structure of the programs and, therefore, their cost.

You can go to evening law school for $3,000 a year, why is it necessary to offer more than $5,000 worth of educational expenses? If someone is working full time, it is awfully hard to build up that amount of tuition cost at the same time. Would you comment on whether this would be a functional program at, say, $3,000?

Mr. SPERANZA. Why don't I start with that. First of all, I am not sure how many law schools you can go to for $3,500, but that aside, I have seen the real benefits of this program and our community in the communities where we do business.

I will give you two examples in my own department, for example. I hired a secretary, a single parent who couldn't afford an education. Secretaries don't make a lot of money, a high school graduate.

Chairman JOHNSON. I don't disagree with you. It is the merit of the program. I have lost people from my staff because I didn't have the ability to do this for them, and they wanted to finish school and they couldn't afford any other way. I see its mobility implications and the power it has to simply allow people to get the education they need that they couldn't otherwise afford, but what are the dollar dimensions of the necessary support?

If you get 3,000 dollars' worth of support for tuition and books and you are working full time, is that enough?

Mr. SPERANZA. All I can say as a practical matter from our experience, it has been enough. Most of our employees are in New York State. We have a good public education system. You can get a college education at a State college, the State University of New York, for example, for a tuition of $2,500. Those dollars are very important, and as I said before, I have seen people who could not afford, who were using every penny to put food on the table for their children.

Chairman JOHNSON. Oh, I agree.

Mr. PORTMAN. They didn't have the opportunity and now they do. They have graduated. I have one particular secretary who got a 4.0 average at a local school, and now she is an executive in our company. She could not have had that opportunity without a scholarship, and we have a number of stories like that.

Mr. HUNT. I would be worried about setting a number, just because numbers end up causing problems. I see your concern, and I think it is a good one.

I think the nice part, again going back to Mr. Portman's thing, is whatever your investment is, whatever the person makes, you are going to see it coming back in taxes, and I know there is some—

Chairman JOHNSON. The number in the law now—

Mr. HUNT. I am sorry?

Chairman JOHNSON [continuing]. The number in the law now is $5,250.

Mr. HUNT. Yes, ma'am.

Chairman JOHNSON. That is a reduction from a higher number that we adopted a few years ago. These numbers are important from the point of view from the Congressional Budget Office estimating the possible cost of this program.

If $3,000 is about as much as anybody really uses anyway and if that will do the job, then we want to bring that number down. That is really what I am asking.

Mr. Brown, do you have any comment on that? Do you know what it cost you per year?

Mr. BROWN. Last year, was about $4,000.

Chairman JOHNSON. That is interesting.

Mr. BROWN. I think limiting the number would sort of limit the opportunities of the schools you could choose.

Chairman JOHNSON. Yes, it does. It would certainly do that. It would focus you on the public institutions—

Mr. BROWN. Right.

Chairman JOHNSON [continuing]. The lower we drop the tuition. That is absolutely true.

Mr. BROWN. I guess the other important part of it is there is a company where I live, and 82 percent of their employees go to my particular community college. The numbers of those employees had dropped off with the expiration of 127, and this company looks for their employees to come to school to help increase their productivity as far as the company is concerned. When those numbers go up or go down, it gets kind of monotonous at times.

Chairman JOHNSON. Thank you very much.

I am going to recognize Mr. Levin of Michigan, and then he will recognize our other colleagues.

Mr. LEVIN. Mr. Portman will come after me.

All right. I will be brief. I think that the distinguished Chair of the Subcommittee has put her finger on some of the problems and the need, and your testimony is so important. I think we have to go in our thinking beyond the days when there was a rigid separation between work and education.

I am finding more and more as I go into plants, for example, the intimate relationship between the workplace and learning the skills and upgrading your skills.

I think this provision is today far more significant than it was when it was passed. In that sense, legislation—it doesn't always happen—was ahead of its time.

Let me ask you, one of the criticisms is that this program benefits too many higher paid workers. What is your experience? Who have been the main recipients? I think the beneficiaries are the companies as well as the workers, but in terms of the participants, what has been your experience, any of the three of you?

Mr. BROWN. If it is beneficial for higher paid workers, especially at my institution, that hasn't happened.

Colling-Myers, which is a furniture company, Chic-Fil-A, which is a fast-food chain, offer $2,000 benefits. They give their employees—who are still making basically minimum wage or maybe 50 to 75 cents more than the minimum wage—give them $2,000 to go to school, and there is a vast number of those that are attending school.

As a matter of fact, I would say that a majority of the 11,000 and some odd students that attend my institution, are in lower income jobs. We are talking $30,000 and below.

Mr. SPERANZA. If I could respond to that question as well, Congressman, in our industry which is the food industry, there are not necessarily well-paid jobs at entry level. The skills they learn at college can get them into some higher paying jobs, but to put it in perspective, when you are talking about $5,000 as an upper limit for help, our program is much less than that.

A private college education today probably costs $25,000 to $30,000. We are not talking the upper end or even the upper middle. You are talking about people who are scraping by, who have no alternative but a community college or a State school, and this covers a good portion of that tuition, not all of it necessarily. We think people should help themselves, also, but that is the group we are targeting. It is the people coming out of high school, the people who are struggling to perhaps try college, people who have lost jobs, career changes, and that sort of thing. We think the target is right on.

Mr. HUNT. I think there is another factor to remember as well. We often talk about highly paid. I heard earlier they were talking about Boeing aircraft, when they laid off umpteen people. You might have been a $100,000 engineer. You just got laid off. You're a zero-dollar engineer, but people are going to say, "You know that $100,000 guy? Well, he needs to suddenly get retrained for something."

Also, I think that there are a lot of stories that are going on now. We are hearing that bank tellers are going to be rare nowadays. There are going to be a lot of major changes in white-collar jobs.

I am 48, and there are a lot of people just a year or two ahead of me who finished college before computers were really known. They have no background. They are going to be stymied. They may be making a lot of money now, but they are hitting a glass ceiling and all that, or if they get laid off, where are they going to go?

Keep in mind when you talk about upper income and all, it may be the income that they are making today, and they may need to be retrained. Be looking at that.

I think it is one of these nice things that we will do. Plus, if that $100,000 former Boeing engineer is reemployed, he is going to be paying pretty high taxes and at the highest tax rate.

I think as you said, it is one of those nice things. It is a win-win for the government and for all segments of society.

Mr. LEVIN. Thank you very much.

Mr. PORTMAN. I think my colleague from Michigan is correct in saying the program, in some respects, was ahead of its time.

Mr. Hunt, you had referred to some of the dialog we had had earlier. I was talking about the white-collar issues in my district and the fact that there is so much transition. I believe now that the typical kindergartner will have 14 careers in his or her life. I think this is an important provision.

I will say, getting back to the fiscal conservative role and our need to target and to streamline these programs, that it is not a perfect program. It could be improved.

One thing that many of us, of course, have thought about, which is consistent with Mr. Levin's question is some kind of means testing. The $100,000 engineer, if he is laid off from Boeing, that is one thing, and he would be receiving unemployment assistance for some period of time, but if he continues at $100,000 a year and is being retrained for a new job, he is still getting $100,000 a year, although his prospects for the job he has are not good. He is being retrained.

Should he receive the same exclusion from income, which is all the more important to him, at $100,000 than it is for somebody making $35,000, the person at the lower level, that is one question I have had of this program. Is there an appropriate means testing in this program? What would that mean for you and others?

Mr. HUNT. I think that one of the things we are seeing today is there is often a big difference. It is not, hot and cold, being fired. There is handwriting on the wall.

I will pick on the poor, old bank tellers again. If I were a bank teller right now, I have not been fired, but my guess is that I don't have a long career ahead of me. That is a shrinking field, and it is the same with a number of different industries as you look around. Things that used to be big, thriving industries are shrinking, senior bank executives being another example.

I think that is one of the things, and perhaps we see it in the association field. Somebody will say, "Yes, I have been in this part of the industry, but gosh, I see the trend is going to be over here." You get to the point, all right, he is making $100,000 today, but he knows that is going to fizzle out in a few years, that whole area of business. He can either ride it down, and then you have got him down here and what to do, and of course, usually it happens when he is at the height of his mortgage and everything else, or you can make it a smooth transition.

I think that there is a factor there, and again, I think it is one of those things that pays for itself in terms of even when the person is at the higher level, he is probably going to get a pay raise if he has got a better education or he has learned about things, how to use computers, or whatever it may be.

One of the nice things that is most cost effective in terms of the association programs is they tend to be very targeted. You may be a college graduate and suddenly find yourself in midlife crisis and don't know what you are doing. You can go and get some specific course through association, and that usually costs a lot less.

Mr. PORTMAN. Your suggestion is that even at the $100,000 level, in the end it is a good bargain for the government to provide some assistance for retraining or additional education because even that person will be a net cost to the government should that person sort of fall off the fast track and end up being in need of public assistance or some other government subsidy?

Mr. HUNT. I think so, but like you, I am a fiscal conservative. I probably just think that is hard to say, and yet, when I kind of think through the math of it, if the person is down for a few years, you are certainly going to see his tax revenues go down. If you go across at that level, you are paying big tax dollars. Common sense kind of walks me through and says it does pay out.

Mr. SPERANZA. I have just one comment.

Mr. PORTMAN. Yes, Mr. Speranza.

Chairman JOHNSON. The anecdote of the $100,000 individual, I think, is quite dangerous.

Mr. HUNT. Exactly.

Mr. SPERANZA. We don't have any $100,000 people in our industry that benefit from this program, nowhere near that. They bag groceries.

I think there may be a person or two, that may sneak through at that level of income, but when we are talking about the people in our industry, which is a very basic industry, we don't see that. If there is going to be a means test and I would prefer that there wouldn't be. It should be done in such a way that you don't have substantial Government intervention and more paperwork which discourages the very people who need the help, I think that would be a key consideration.

Mr. HUNT. That is very valid. That goes to our earlier testimony.

Mr. PORTMAN. Are there any other improvements you could see for the current program? One idea, of course, I guess, under 162, you can take a miscellaneous deduction, an itemized deduction for job-related training currently, and some have argued that this provision isn't necessary because it should be job related and you can go through the paperwork to get the deduction if it is job related.

Do you think that would make any sense to try to have some link to the job?

Mr. SPERANZA. I could speak to that. In our kind of program, absolutely not. For example, what we are trying to do is train people for the future, give them additional skills.

We are starting out at entry level. We have got people in the program who have gone to medical school, to law school, graduate programs, and so forth, but the bulk of them community colleges, State schools, and so on. I wouldn't think that that would be the way to go.

Mr. PORTMAN. Absolutely.

I yield to the gentleman from Michigan.

Mr. LEVIN. I have been thinking about that, and since we have a common interest here, if it would otherwise be covered, I don't think it would be scored as costing or saving several billion dollars. So there must be considerable numbers.

Mr. PORTMAN. Who are not in that category.

Mr. LEVIN. I think so.

Mr. PORTMAN. Yes.

Mr. LEVIN. Otherwise, by abolishing section 127, we would get close to a zero cost or cost savings.

Mr. PORTMAN. I think, if the gentleman will yield back, I think you are correct, and my only question was whether there is an argument for making the section 127 exclusion from income job related, not so much that section 127 would subsume all the activities, but is there a way to narrow the current exclusion and, therefore, have it more targeted? I am not sure I would support that, personally, but I throw that out as an idea for further clarification.

Mr. LEVIN. Thank you.

Mr. HUNT. I think you would find people would be getting into spitting matches constantly with IRS where you would have conservative tax departments of companies.

If one of his baggers, for instance, says, "Gee, I would really like to have his job, to be general counsel of the company some day," and he wants to go to law school, obviously I think the IRS would look and say no way does law school have anything to do with bagging.

I think you would constantly be in a spitting match over that, and this is what I have heard from oldtimers, meaning pre-1978.

Mr. PORTMAN. That also gets to your concern about the cost of the compliance and paperwork in the program.

Mr. HUNT. Or just the general chilling effect that it would have on people, and especially we are talking about looking ahead to changes. There are things that we don't know that are going to happen in, say, the year 2000 that we are probably all have to be retrained for that would not necessarily be job-specific. Is the IRS going to always be on the cutting edge of knowing what is going to be best for me?

Mr. PORTMAN. Right.

Mr. SPERANZA. The bottom line, Congressman, is to allow people to help themselves. You have people at the entry level jobs who are trying to get ahead. If you have job related training only, why would somebody want to get an education to be a better cashier? They want to get into management and so on. For an industry like ours and similar situated industries, it makes no sense.

The last comment I would have is we think the program is so important we would like to keep it just the way it is with the permanent extension, but if that can't be, the second best thing is lowering the amount.

Mr. PORTMAN. The $5,250 amount?

Mr. SPERANZA. Correct.

We would certainly want it the way it is, but I would hate to get rid of the whole program, which is very, very effective, because of the cost constraints.

Mr. PORTMAN. One final question. We now have an official Chairman here sitting in the chair and everything, but, Mr. Brown, your personal experience when you went back to school or went to school, was this directly related to your responsibilities at work or was it to broaden your horizons and get into other areas?

Mr. BROWN. I started off actually in a work study situation. My reasons for wanting to go to school—well, I had ambitions of being a public administrator, basically a medical administrator. I got into a public administration curriculum.

A lot of the courses that I take are basically governmental courses. I have had courses in social work, fiscal administration, you know, different things like that. Of course, you have the other classes that really have nothing to do with that particular job, like your electives and things like that, but for me, it is very beneficial for what I want to do at the VA, Veterans Administration, hospital, or in some type of medical system of being an administrator as opposed to a worker.

I am starting off at the entry level where I work in the Medical Records Department. Basically, I take care of over 1 million records at the hospital. By getting this type of degree, it will help me achieve what I ultimately want to do, and that is to be a public administrator in a medical field.

When I look at the way this Tax Code is, two different entities benefit from this. The hospital benefits because I get more education. I will be able to put more into my job, and eventually as far as promotion is concerned, and the government comes out as well because the more I make, the more taxes I pay.

The local government is a beneficiary as well because the more I make, the better house I may live in or the better neighborhood. My property taxes go up. They are making money, and that is just how I see the whole thing.

Mr. PORTMAN. Thank you all for your testimony. I appreciate it.

Mr. SPERANZA. You are welcome.

Mr. HERGER [presiding]. Thank you very much. We appreciate your testimony. Thank you.

The next panelists will step forward, please. They are Linda Chase, vice president, corporate affairs, Auto Club of Hartford, Connecticut, on behalf of the Society for Human Resource Management; Pamala Easley, payroll supervisor, Vinnell Corp., on behalf of American Payroll Association; Robert D. Williamson, president, American Society for Payroll Management; Stafford E. Thornton, president, American Society of Civil Engineers; and Ross J. McVey, assistant controller, director of tax, Telephone & Data Systems, Inc.

Ms. Chase, if you would begin your testimony, please.

STATEMENT OF LINDA CHASE, VICE PRESIDENT, CORPORATE AFFAIRS, AUTO CLUB OF HARTFORD (AAA), HARTFORD, CONNECTICUT; ON BEHALF OF SOCIETY FOR HUMAN RESOURCE MANAGEMENT

Ms. CHASE. Thank you.

My name is Linda Chase. I am the vice president of corporate affairs for the Automobile Club of Hartford in Hartford, Connecticut, which is an affiliate of the American Automobile Association, also known as AAA.

I am testifying today, however, on behalf of the SHRM, Society for Human Resource Management. SHRM is the leading voice in the human resource profession. SHRM represent the interests of more than 66,000 professional and student members in 435 chapters from all 50 States.

On behalf of SHRM, I wanted to thank you for this opportunity to appear before this Subcommittee to express our support of a permanent extension of section 127 of the IRC.

I would also like to thank Congressman Shaw of the Full Committee and also Congressman Levin of this Subcommittee for all of your work. We do appreciate that support.

I would like to offer for your consideration AAA's approach to human resources, we do place a high value on education, mutual respect, and the shared value of our employees, and we feel that there are no guarantees of success in the business world. However, AAA has found that if we invest in our employees and challenge ourselves to learn, we can achieve a level of service in the motoring, travel, and insurance industry that is unparalleled, and I will tell you why.

The only tool, the only resource that our competitors cannot reproduce is our people. They can build new facilities and they can

pay their workers less and they can take shortcuts in customer service, but our people are unique, and that is what makes AAA a leader in our field.

In the same way, if we are to be a productive and competitive Nation, we must use our limited resources wisely. Section 127 represents the kind of investment worthy of Federal support.

On the average, employees with 4 or more years of college earn 70 percent more than employees with only a high school degree. Higher income leads to increased tax liability, and the government easily recoups its investment over the trained worker's lifetime.

Section 127 is the right tool for the entire business community. Businesses don't just give away money. We provide educational assistance because it helps us attract good workers, keep them, and help them to become even more productive employees, and that is why temporary extensions of 127 have been unsatisfactory. The temporary extension brings about tremendous administrative problems as long-range plans for training are disrupted.

While there is another IRC, section 132, that allows for the narrow exclusion of strictly job related assistance, businesses cannot comply with a standard that requires us to guess whether the IRS will consider it job related every time we send a worker for training.

Limiting our employees to only job related education also restricts employers in their efforts to cross train employees and promote from within.

While education is important for everyone, low-income workers, in particular, rely on employer-provided assistance to improve their career prospects. These employees, who may be hired initially to take care of routine administrative functions, take advantage of section 127 to gain skills for higher paying jobs.

Limiting these workers to job related education only is, in essence, relegating them to training for skills that cannot help them get ahead. The American dream is all about advancing through hard work and education, not just maintaining the same status in the same job.

I am an example of a lower paid, lower income worker that has risen in one particular company because of section 127. At AAA, I have been there for 13 years, and I started coming out of college where I had a very narrow degree. I went to AAA as an entry-level telemarketing representative and became an auto travel counselor. From there, I moved into the public relations field, and I didn't know anything about it. I had to be educated on the job, and my company supported that.

From there, I moved into human resources, and today I am the vice president, after 13 years. I highly support section 127's extension.

Laid-off employees, in turn, are also affected by the loss of section 127. In Connecticut, we have an awful lot of downsizing going on, and through section 127, in some cases, laid-off workers often have the shock of the job loss somewhat lessened when their former companies pay for training for other jobs available in the community that they could assume.

Without section 127, the laid-off employees would be taxed on that training at the very time they have no income and desperately need help in securing another job.

With section 127, on the other hand, our workers have a chance to broaden their educations and prepare for the higher skilled jobs they currently do not have, but are within reach through education.

I would like to thank this Subcommittee for its time today, and I hope that you will continue to call in AAA and the Society for Human Resource Management as you seek to restore and extend the exclusion for employee educational assistance.

Thank you.

[The prepared statement follows:]

STATEMENT OF LINDA CHASE
VICE PRESIDENT FOR CORPORATE AFFAIRS, AUTO CLUB OF HARTFORD
ON BEHALF OF THE
SOCIETY FOR HUMAN RESOURCE MANAGEMENT

Madame Chairman, my name is Linda Chase and I am the Vice President for Corporate Affairs of the Auto Club of Hartford in Hartford, Connecticut, part of the American Automobile Association, also known as AAA. I am testifying today on behalf of the Society for Human Resource Management.

SHRM is the leading voice of the human resource profession, representing the interests of more than 66,000 professional and student members in 435 chapters from all 50 states.

On behalf of SHRM, I wanted to thank you for the opportunity to appear before the Subcommittee to express our support of a permanent extension of Section 127 of the Internal Revenue Code.

SHRM members work for organizations employing over 80 million American workers. SHRM, however, has no corporate members-- only individuals. This protects the independence of our human resource professionals and allows them to continue in their role of being effective liaisons between employers and employees.

As human resource professionals work to recruit, train and retain employees, we hear directly from both employers and employees regarding which programs work. Since we also administer those programs, human resource professionals are uniquely positioned to give balanced input on which are the best and most effective policies in the workplace-- and I can tell you unequivocally that Section 127 works.

I would also like to thank Congressman Shaw of the full Committee and Congressman Levin of this Subcommittee for introducing H.R. 127, legislation that would permanently extend Section 127. We appreciate their work and the support of other members of Congress who have demonstrated their commitment to continuing education by cosponsoring this bill.

Madame Chair, Congress has a difficult job. As elected representatives, we recognize that you are challenged daily to make tough choices. You must weigh options, balance competing interests and make policy judgments based on what is best for the nation.

Although I am not elected to public office, I offer for your consideration AAA's approach to human resources: we highly value education, mutual respect and the shared values of our employees.

There are no guarantees of success in the business world. However, AAA has found that if we invest in our employees and challenge ourselves to learn, we can achieve a level of service in the motor, travel and insurance industry that is unparalleled.

I'll tell you why: The only tool, the only resource, that our competitors cannot reproduce is our people. They can build new facilities, pay their workers less, and take shortcuts in customer service. But our people are unique, and that is what makes AAA a leader in our field.

As part of its training initiative, AAA makes broad use of Section 127, educational assistance. Our workers like it, and I can testify of its impact on our workforce. Educational assistance is one of the tools that AAA uses to make it the company it is today.

In the same way, educational assistance is a key tool for all of America, and Section 127 represents a solid investment for the government. The Bureau of the Census confirms what we already know when it reports that education is the key to higher income. On average, employees with four or more years of college earn 70 percent more than employees with only a high school degree. Greater income leads to increased tax liability, with the government easily recouping its investment over the trained worker's lifetime.

Section 127 is the right tool for employees because it represents an unparalleled opportunity for workers. It empowers workers. It gives them a chance to broaden their expertise in many areas, beyond typical work-based training.

Madame Chair, Section 127 is the right tool for the entire business community. Businesses don't just give away money. We provide educational assistance because it helps us attract good

workers, keep them, and help them to become even more productive employees.

And that is why temporary extensions of Section 127 have been unsatisfactory. The temporary extensions bring about the tremendous administrative as long range plans for training are disrupted. While there is another Internal Revenue Code Section, Section 132, that allows for the narrow exclusion of strictly job-related assistance, businesses cannot comply with a standard that requires us to guess whether IRS will consider it job-related every time we send a worker for training. Limiting our employees to only job-related education also restricts employers in their efforts to cross-train employees and promote from within.

Although it hurts business, the loss of Section 127 is even worse for two groups-- current employees and laid off workers. Our employees have their educations disrupted in many instances, and their career aspirations are therefore put on hold.

While education is important for everyone, low income workers in particular rely on employer provided assistance to improve their career prospects. These employees, who may be hired initially to take care of routine administrative functions, take advantage of Section 127 to gain skills for higher paying jobs. Limiting these workers to job-related education only, is in essence relegating them to training for skills that cannot help them get ahead. The American Dream is all about advancing through hard work and education, not just maintaining the same status in the same job.

Laid off employees, in turn, are also affected by the loss of Section 127. In Connecticut we have had a lot of down-sizing. With Section 127, laid off workers often have the shock of the job loss somewhat lessened when their former companies pay for training for other jobs available in the community. Without Section 127, these laid off employees would be taxed on that training at the very time they have no income and desperately need help in securing another job.

With Section 127, on the other hand, our workers have a chance to broaden their educations, and prepare for the higher skilled jobs they **currently do not** have, but that are within reach through education.

We are in a fierce competition with other countries of the world, and our economic prosperity is at stake. We must use all of our available tools and resources to win.

I thank the Subcommittee for its time today, and I hope that you will continue to call on the Automobile Club of Hartford and the Society for Human Resource Management as you seek to restore and extend the exclusion for employee educational assistance.

Mr. HERGER. Thank you, Ms. Chase, for your testimony.
Ms. Easley.

STATEMENT OF PAMALA EASLEY, PAYROLL SUPERVISOR, VINNELL CORP., FAIRFAX, VIRGINIA; ON BEHALF OF AMERICAN PAYROLL ASSOCIATION

Ms. EASLEY. It is a pleasure for me to testify today on the important issue of the tax treatment of employer-provided educational assistance under section 127 of the IRC.

My name is Pamela Easley, and I am here on behalf of the APA, American Payroll Association.

The APA is a nonprofit, professional association representing over 11,000 companies and individuals on issues relating to wage and employment tax withholding, reporting, and depositing. Over 85 percent of the gross Federal revenues of the United States are collected, reported and/or deposited through company payroll withholding.

Under our system of voluntary compliance, payroll professionals, like me and my colleagues, are the Nation's tax collectors. For nearly 10 years, I have supervised the payroll operations for Vinnell Corp. in Fairfax, Virginia. Vinnell is a government contractor that, among other things, provides operations and maintenance assistance to U.S. military bases worldwide.

As part of its employee benefits package, Vinnell will reimburse its employees for up to $1,500 in tuition expenses per year which, as I will discuss later, I take full advantage of.

The APA strongly supports the withholding exclusion for education benefits under section 127. The on-again-off-again treatment of this important provision by Congress, however, has created an enormous amount of extra work for U.S. businesses. These problems are intensified when authorization expires midyear and is then reinstated retroactively, as was the case in 1993, and we fear may be the case this year.

In addition, this lack of permanency creates a hardship for working Americans and strains relationships between U.S. businesses and their employees.

First, I will discuss the administrative burdens that these repeated expirations have created. In 1993, when the provision was last reinstated, our company experienced a great deal of extra and costly paperwork. The worst problems came in making the adjustments for employees who had educational expenses in 1992. Because the authorization was reinstated retroactively, these employees had, in effect, overstated their income on their 1992 tax returns and were, thus, entitled to get money back for the Federal and State income taxes and for their share of FICA.

Vinnell was entitled to reimbursement for the employer's portion of FICA, but had to go through a great deal of time and costly paperwork to collect it.

In order to enable employees to get their refunds, we had to calculate the difference in the taxable wages for employees entitled to reimbursements, complete a W–3C, the cover sheet for corrected wage statements, and process and distribute corrected wage statements, W–2Cs.

We then had to ask the employees to sign a statement promising that they would not seek a FICA reimbursement from the government, and then we needed to manually cut checks to reimburse employees for FICA overpayments out of our own account.

Meanwhile, we had to tell the employees that in order to get a Federal tax refund, they would have to file an amended tax return. We made it as easy as we could for employees by providing them with copies of form 1040–X so they could amend their tax returns, but it was up to the individual employee to complete the form and send it in to the IRS.

To straighten out our own books and remain in compliance, we had to file amended quarterly tax returns, form 941–C and form 843, request for refund, seeking a refund for both the employer's and employee's portion of FICA.

It took me, along with my two assistants, a full week to sort out the problems. Figuring in labor and overhead, I estimate we spent about $3,000 on this project, and that is with only about 20 employees in our headquarters office taking classes.

I shudder to think about the time and money spent by my colleagues at Vinnell's parent company, BDM International, where I am told some 500 employees were affected.

The changes in the tax status of section 127 causes enormous confusion for employees who receive the benefit. Each time the provision expired, my staff, along with our human resources department, spent endless hours explaining and assuring our employees that the company was not voluntarily taking a promised benefit away.

The employees thought they were to receive a tax-free benefit for educational expenses for a certain amount and budgeted accordingly. In fact, the amount is reduced, and they don't understand why.

Although we forewarned the employees, the messages did not really get through until the workers saw the difference in their take-home pay.

I would like to stress that management at Vinnell realizes that they do not have to offer their educational benefit under increasingly difficult section 127. We could alternatively offer them under the more stable section 132 exclusions, but Vinnell has made the business decision to allow employees to advance their careers by enrolling in a broad range of courses, not just those they need for their current jobs.

Through this policy, we avoid the undesirable situation in which we would agree to reimburse one employee for a particular course that was necessary for the job, but we would have to say no to other employees who may want to take the same course in order to advance their careers.

At this point, I would like to talk a little bit about my own circumstances. In addition to being a payroll supervisor, I am also a student benefitting from Vinnell's educational assistance program.

I have been enrolled at the Woodbridge campus of the Northern Virginia Community College for 2 years. So far, I have taken four courses, and I have a grade point average of 4.0.

I am here to testify that the $1,500 that I had been receiving from Vinnell is vitally important to me. Three years ago, my hus-

band had his second open heart surgery after suffering a massive heart attack. He is now totally disabled. As a result, I am the sole wage earner for my family. I also have a 14-year-old daughter and a 16-year-old son. They, too, would one day like to go to college, and I would like to be a role model and provide financial assistance for them.

There is one last point that I would like to make. In conversations with my colleagues, a clear profile of the kind of employees who benefit the most from section 127 has emerged. Like myself, they tend to be women. Many are single parents. All are struggling financially. The educational assistance they get from their employers may be one of the few financial breaks they ever get in their lives.

I urge you to give full commitment to this important provision and make it permanent as proposed in H.R. 127, the Employee Educational Assistance Act of 1995. If that proves impossible, however, I hope you will stop hitting U.S. businesses with unnecessary and costly paperwork. This can be accomplished if you set the expiration date at the end of the year and not allow the provision to lapse. If you opt once again making the withholding exclusion retroactive, I urge you for the reasons outlined to work quickly and reinstate it this calendar year.

Thank you again for this opportunity to present my views as a paraprofessional and as a student. I would be pleased to answer any questions from you or your staff.

[The prepared statement follows:]

Testimony of the
American Payroll Association

Presented by Pamala Easley, CPP
Payroll Supervisor, Vinnell Corporation

It's a pleasure for me to testify today on the important issue of the tax treatment of employer-provided educational assistance under Sec. 127 of the Internal Revenue Code.

My name is Pamala Easley and I am here on behalf of the American Payroll Association (APA). The APA is a non-profit professional association representing over 11,000 companies and individuals on issues relating to wage and employment tax withholding, reporting and depositing. Over 85 percent of the gross federal revenues of the United States are collected, reported and/or deposited through company payroll withholding. Under our system of voluntary compliance, Payroll Professionals are the nation's tax collectors.

For nearly 10 years, I have supervised the payroll operations for the Vinnell Corporation in Fairfax, Virginia. Vinnell is a government contractor that, among other things, provides operations and maintenance assistance to U.S. military bases world-wide. As part of its employee benefits package, Vinnell will reimburse its employees for up to $1,500 in tuition expenses per year.

The APA strongly supports the withholding exclusion for education benefits under Sec. 127. The on-again, off-again treatment of this important provision by Congress, however, has created an enormous amount of extra work for U.S. businesses. These problems are intensified when the authorization expires mid-year and is then reinstated, retroactively, as was the case in 1993 (and, we fear, may be the case this year.) In addition, this lack of permanency creates hardship for working Americans and strains relationships between U.S. businesses and their employees.

First I will discuss the administrative burdens that these repeated expirations have created.

In 1993, when the provision was last reinstated, our company experienced a great deal of extra and costly paperwork. The worst problems came in making the adjustments for employees who had educational expenses in 1992. Because the authorization was reinstated retroactively, these employees had, in effect, overstated their income on their 1992 tax returns, and were thus entitled to get money back for their federal and state income taxes and for their share of FICA. Vinnell was entitled to reimbursement for the employer's portion of FICA, but had to go through a great deal of time and costly paperwork to collect it.

In order to enable employees to get their refunds, we had to:

- Calculate the difference in taxable wages for employees entitled to reimbursements;
- Complete a W-3c, the cover sheet for corrected wage statements; and
- Process and distribute corrected wage statements (W-2c's).

We then had to ask employees to sign a statement promising that they would not seek a FICA reimbursement from the government. And then we needed to manually cut checks to reimburse employees for FICA overpayments out of our own account.

Meanwhile, we had to tell employees that in order to get a federal tax refund, they would have to file an amended tax return. We made it as easy as we could for employees by providing them with copies of the Form 1040X so they could amend their tax returns. But it was up to the individual employee to complete the form and send it in to the IRS.

To straighten out our own books and remain in compliance, we had to file amended quarterly tax returns (Forms 941c) and a Form 843 (Request for Refund), seeking a refund for both the employer's and employees' portion of FICA.

Processing the reimbursements for employees who took classes in 1993 was a bit easier because the changes applied to the current calendar year. However, we still had to reimburse employees for the money that we had withheld and reduced their taxable income up until the point that the provision was reinstated. Again, those checks had to be cut manually. And then we, as a company, had to adjust our federal tax liability.

It took me, along with my two assistants, a full week to sort out the problems. Figuring in labor and overhead, I estimate we spent about $3,000 on this project -- and that's with only about 20 employees in our headquarters office taking classes. I shudder to think about the time and money spent by my colleagues at Vinnell's parent company, BDM, International, where I'm told some 500 employees were affected.

The change in the tax status of Sec. 127 causes enormous confusion for employees who receive the benefit. Each time the provision expired, my staff, along with our Human Resources Department, spent endless hours explaining and assuring our employees that the company was not voluntarily taking a promised benefit away from them. Employees thought they were to receive a tax free benefit for educational expenses for a certain amount and budgeted accordingly. In fact, the amount is reduced and they don't understand why. Although we forewarned employees, the message didn't really get through until workers saw the difference in their take home pay.

Our workers' confusion and frustration is compounded if they talk to friends and family members at other companies where withholding isn't taken out. And that brings up another problem: Many companies have begun to avoid this hardship for employees by gambling on the deduction being reinstated. As a result, they don't withhold.

When the provision expired in 1992, the APA took a straw poll among mostly large employers. Twenty-one of the 29 respondents to our informal survey -- more than 72 percent -- gambled on Congress enacting a retroactive extender, as it had done five times previously. As a result, they did not follow the letter of the law and neither reported nor withheld, as they were required to do.

On the other hand, compliant companies like Vinnell were, in effect, punished for their compliance. We had to spend the time and money revisiting our records and going through the procedures I have already outlined.

To date, I have gotten assurances from management that Vinnell is committed to its educational assistance benefit and has no plans to terminate it, despite the burden it has caused. It maintains this commitment even though the benefit:

- now costs as much as $167 more per employee. (The extra cost is incurred when an employer absorbs its share of FICA, as well as federal and state unemployment on the tuition reimbursement);

- causes extraordinary administrative burden and costly paperwork for businesses that must correct their wage records each time there is a retroactive change; and

- causes employee relations problems and low morale.

It seems to me, some other companies would think about discontinuing this voluntary, pro-employee benefit under these harsh circumstances.

I'd like to stress that management at Vinnell realizes they do not have to offer their educational benefit under the increasingly problematic Sec. 127 exclusion. We could, alternatively offer them under the more stable Sec. 132 exclusion. But Vinnell made the business decision to allow employees to advance their careers by enrolling in a broad a range of courses -- not just those they need for their current jobs. Through this policy, we avoid the undesirable situation in which we would agree to reimburse one employee for a particular course that was necessary for the job, but would have to say "No" to other employees who may want to take the same course in order to advance their careers.

In addition to being a Payroll Supervisor, I am also a student benefitting from Vinnell's educational assistance program. So I know, from my own personal experience, just how important the withholding exemption is and just how hard working Americans are hit by the non-permanent status of this provision.

I have been enrolled at the Woodbridge campus of the Northern Virginia Community College for two years. I am working towards three Associate degrees: in computer science, accounting and business administration. So far, I have taken four courses and have a 4.0 grade point average.

Although I still have a long way to go to complete my course requirements, I fully intend to apply my credits from NOVA towards a bachelor's degree at a four-year school. My career goal is to develop payroll software packages for companies like Vinnell.

I am here to testify that the fifteen hundred dollars that I had been receiving from Vinnell is vitally important to me. Three years ago, my husband had his second open heart surgery after suffering a massive heart attack. He is now totally disabled. As a result, I am the sole wage earner for my family. I also have a 14-year old daughter and a 16-year old son. They, too, would one day like to go to college. I would like to be a role model for them and provide financial assistance for them.

But with the future of Sec. 127 so cloudy, I wonder if I will be able to afford to continue my own education, let alone help out my children. Before Sec. 127 expired, I was reimbursed for the full cost of my courses, up to $1,500. Now, however, once the various taxes are taken out, I will receive only about two-thirds of that. As long as Sec. 127 is defunct, I must come up with the difference on my own. And once I transfer to a four year college, my costs will increase by as much as 380 percent.

There is one last point I would like to make. Through conversations with my colleagues, a clear profile of the kind of employees who benefits the most from Sec. 127 has emerged. Like myself, they tend to be women. Many are single parents. All are struggling financially. The educational assistance they get from their employers may be one of the few financial breaks they ever get in their lives. I urge you to give a full commitment to this important provision and make it permanent as proposed in H.R. 127, the Employee Educational Assistance Act of 1995. If that proves impossible, however, I hope you will stop hitting U.S. businesses with unnecessary and costly paperwork. This can be accomplished if you set the expiration date at the end of the calendar year and not allow the provision to lapse. If you opt to once again make the withholding exclusion retroactive, I urge you, for the reasons outlined already, to work quickly and reinstate it this calendar year.

Thank you again for this opportunity to present my views as a Payroll Professional and as a student. I would be pleased to answer any questions from you or your staff.

Mr. HERGER. Thank you, Ms. Easley.

Mr. Williamson, if you would testify, please, and if we could try to keep our testimonies to approximately 5 minutes if we could, please.

STATEMENT OF ROBERT D. WILLIAMSON, PRESIDENT, AMERICAN SOCIETY FOR PAYROLL MANAGEMENT, NEW YORK, NEW YORK

Mr. WILLIAMSON. Thank you, Mr. Chairman. This will be very succinct.

Thank you for the opportunity to appear before the Subcommittee today. We appreciate the Subcommittee's interest in hearing from the payroll community because our members, the managers responsible for payroll and employment taxes of large firms, are the people who have had to handle the administrative consequences of the on-again-off-again status of the tax break for nonjob related educational assistance.

Section 127 has caused problems in payroll for more than a decade. It has expired six times and has been restored retroactively five times.

By 1992, many employers ignored the expiration of the tax break in anticipation of the usual restoration. We did a survey at that time, and it showed it was about 50/50.

Compliant employers had tax reimbursements they made during the last 6 months of 1992 and included the amounts on their W–2 forms and employment tax returns. They were sorry they did because the following year OBRA 1993 restored the tax break retroactively. This changed formerly compliant employers to noncompliant, and the formerly noncompliant to compliant.

To make the administrative consequences worse, ASPM's, American Society for Payroll Management, recommendation that corrections to tax returns and information statements for 1992 that could be reported on 1993 forms was turned down. The result? The formerly compliant, now noncompliant employers issued W–2Cs, W–3Cs, 941–Cs, and State forms, and affected employees presumably corrected their individual 1040 tax returns. Thus, the formerly noncompliant made compliant by OBRA 1993 did nothing and we are off the hook.

Today, May 9, the payroll people are in the same quandary. Should they act on the expiration of the tax break or should they blink and wait for another retroactive reinstatement?

Here is what Clark G. Case, payroll manager of the city of Winston-Salem, North Carolina, has to say:

> We are paying educational assistance as fully taxable income to Federal income tax, FICA, and State taxes. The last time section 127 expired, we continued to pay it as nontaxable, counting on Congress to retroactively activate it. This time,

this means this year,

> I decided that the odds of its extension were not as good as before. We have complied with the taxability. I talked to the guys who do payroll in another State, and they have made the opposite decision and are not taxing the payments because they got burned when they complied the last time. If Congress extends it, it had better be permanent or they will never get me to comply again. It is a real pain to reinstate W–2s and everything else you have to do if it goes past the end of the year. I have already budgeted to increase the benefit by enough to offset the taxability effect on the employees for the coming fiscal year. This almost doubles the cost of

the benefit, but the people who use it are almost uniformly our employees who make less than $24,500 a year, and the taxability effect puts too much of a burden on them to go back for college credit.

Sensible tax policy and good business practice require that section 127 should be permanently settled one way or the other. If it is to be reinstated, the effective date should be January 1, 1995, with relief for compliant employers that would allow them to correct the amounts of tax withheld by adjusting other amounts later in 1995. If the tax break is not reinstated, similar relief should be given to noncompliant employers, the people who incorrectly guessed the 1995 roll of the dice to permit corrections later in 1995 without penalty or interest assessments.

Thank you, Mr. Chairman.

[The prepared statement follows:]

AMERICAN SOCIETY FOR PAYROLL MANAGEMENT

Testimony of Robert D. Williamson, President
before the
Subcommittee on Oversight
May 9, 1995
on
Sec. 127 Employer-Provided Non-Job-Related Educational Assistance

Madame Chairwoman:

Thank you for the opportunity to appear before the Subcommittee today. We appreciate the Subcommittee's interest in hearing from the payroll community because our members, the managers responsible for payroll and employment taxes at large firms, are the people who have had to handle the administrative consequences of the "on-again, off-again" status of the tax break for non-job-related educational assistance. Section 127 has caused problems over more than a decade: it has expired 6 times and has been restored retroactively 5 times:

History of Section 127 Provisions
(source: 1993 Green Book)

1978	Enacted (through 1983)
1983	Expired Dec. 31, 1983
1984	Retroactively extended through 1985 (adopted $5,000 limit)
1985	Expired Dec. 31, 1985
1986	Extended retroactively through 1987 (increased limit to $5,250)
1987	Expired Dec. 31, 1987
1988	Extended retroactively through 1989 (made inapplicable to graduate level courses)
1989	Extended through Sept. 30, 1990
1990	Expired Sept. 30, 1990; retroactively extended through 1991 (repealed graduate level restriction)
1991	Extended through June 30, 1992
1992	Expired July 1, 1992
1993	Extended retroactively through Dec. 31, 1994

By 1992, many employers ignored the expiration of the tax break in anticipation of the usual restoration. (A survey conducted among ASPM members showed that the split between compliant and non-compliant was 50-50.) Compliant employers taxed the reimbursements they made during the last 6 months of 1992 and included the amounts on their W-2 forms and employment tax returns. They were sorry they did because in the following year OBRA 1993 restored the tax break retroactively. This changed formerly compliant employers to non-compliant and the formerly non-compliant to compliant. To make the administrative consequences worse, ASPM's recommendation that corrections to tax returns and information statements for tax year 1992 be reported on 1993 forms was turned down. The result? The formerly compliant (now non-compliant) employers issued W-2c's, W-3c's, and 941c's and related state forms, and affected employees presumably corrected their individual 1040 tax returns. The formerly non-compliant made compliant by OBRA 1993 were "off the hook".

Today, May 9, payroll people are in the same quandary: should they act on the expiration of the tax break, or should they "blink" and wait for another retroactive reinstatement? Here's what Clark G. Case, payroll manager for the City of Winston-Salem, North Carolina, has to say:

"We are paying educational assistance as fully taxable income subject to federal income tax, FICA and state taxes. The last time Section 127 expired, we continued to pay it as nontaxable counting on Congress to retroactively activate it. This time I decided that the odds of its extension were not as good as before, so we have complied with its taxability. I talked to the guys who do payroll at another state and they have made the opposite decision and are not taxing the payments because they got burned by complying last time. If Congress extends it, it had better be permanent or they will never get me to comply again. It is a real pain to restate W-2's and everything else you have to do if it goes past an end of a year. I have already budgeted to increase the benefit by enough to offset the taxability effect on the employees for the coming fiscal year. This almost doubles the cost of the benefit, but the people who use it are almost uniformly our employees who make less than $24,500 per year and the taxability effect puts too much of a burden on them to go back for college credit."

Sensible tax policy and good business practice require that Section 127 should be permanently settled one way or the other. If it is to be reinstated, the effective date should be January 1, 1995 with relief for compliant employers (who taxed 1995 reimbursements) that would allow them to correct the amounts of tax withheld by adjusting other amounts withheld later in 1995. If the tax break is not reinstated, similar relief should be given non-compliant employers, the people who incorrectly guessed the 1995 roll of the dice, to permit corrections later in 1995 without penalty or interest assessments.

Mr. HERGER. Thank you, Mr. Williamson.
Mr. Thornton, if you would testify, please.

STATEMENT OF STAFFORD E. THORNTON, PRESIDENT, AMERICAN SOCIETY OF CIVIL ENGINEERS; ON BEHALF OF AMERICAN ASSOCIATION OF ENGINEERING SOCIETIES

Mr. THORNTON. Good afternoon. My name is Stafford Thornton. I am a registered professional engineer and the president of the American Society of Civil Engineers. I also serve as the director of the Technical Assistance Center at the West Virginia Institute of Technology.

My statement today is being endorsed by the AAES, American Association of Engineering Societies, which represents 800,000 engineers in this country.

I am pleased to be here today to speak in support of permanent extension of 127. ASCE, American Society of Civil Engineers, respectfully recommends a permanent extention of section 127 retroactive to December 31, 1994.

The ASCE as the country's oldest national engineering society, has 115,000 members working in private practice, government, research, and academia. The Society's major goals are to develop engineers who will improve technology and apply it to further the objectives of society as a whole, to promote the dedication and technical capability of its members, and to advance the profession of civil engineering.

ASCE is a strong supporter of the bill introduced by Congressman Levin, the Employee Educational Assistance Act of 1995, which could make section 127 permanent. This bill currently has 87 cosponsors. The legislation has always enjoyed strong bipartisan support on both sides of Capitol Hill.

The American Society of Civil Engineers believes reasonable educational assistance paid for by an employer should not be considered as additional employee income. ASCE supports this exclusion for undergraduate, graduate, and continuing education courses. Currently, section 127 allows employers up to $5,250 per year for each of their employees in tax-free educational benefits.

Over the years, section 127 has been allowed to expire only to subsequently be reinstated, sometimes retroactively. On at least one other occasion, the exclusion for 127 for graduate studies was curtailed, which had a particularly harmful impact on our members.

This unpredictable handling of section 127 has caused confusion among employers and employees, and has tended to discourage rather than promote employer paid educational assistance.

The economic vitality and global competitiveness of the United States are critically dependent upon a highly trained technical work force. Graduate and continuing education for the American civil engineering work force is not a luxury, but rather an essential element of professional practice.

Keeping pace with new and expanding fields of technology demands ongoing education if America is to successfully meet the new reality of intense global competition.

Our members are committed to lifelong learning. There are seven fundamental canon areas. The Code of Ethics states that engineers

shall continue their professional development throughout their careers and shall provide opportunities for the professional development of those engineers under their supervision.

Another facet of this issue is the need to produce quality, educated engineers who can compete with foreign engineers, since it is the policy of most foreign governments and employers to send their students to U.S. universities where foreign students now constitute more than half of the graduate student bodies in many technical fields.

According to the data we have seen, section 127 benefits do not accrue disproportionately to higher paid employees. Nearly 99 percent earn less than $50,000, 71 percent less than $30,000, and 35 percent less than $20,000.

Civil engineers, despite meeting rigorous educational standards, are not among the most highly compensated professionals when compared to other professions. ASCE research reports the average starting salary for civil engineers be $32,000. Having to pay tax up to $5,250 a year, which is the cap under section 127, would certainly be a great burden on many of these people, particularly the ones with families.

With respect to revenue considerations, the modest impact of section 127 on the Treasury, ASCE strongly believes that the benefits to society far outweigh the cost.

On behalf of ASCE and AAES, thank you for allowing me to appear before the Committee today, and I will be happy to respond to any questions.

Thank you.

[The prepared statement follows:]

STATEMENT OF STAFFORD E. THORNTON, P.E.
PRESIDENT, AMERICAN SOCIETY OF CIVIL ENGINEERS

Good afternoon Madam Chair and members of the subcommittee. My name is Stafford E. Thornton. I am a Registered Professional Engineer and the President of the American Society of Civil Engineers (ASCE). I also serve as Director of the Technical Assistance Center at the West Virginia Institute of Technology. My statement today is being endorsed by the American Association of Engineering Societies (AAES), which represents 800,000 engineers nation-wide.

OVERVIEW

I am pleased to be at this important hearing today on extending certain tax code provisions to urge support for Section 127 of the Internal Revenue Code (IRC), which allows individuals to receive tax free employer paid educational assistance. ASCE, which has a long-standing position in support of Section 127, respectfully recommends permanent extension of Section 127 retroactive to December 31, 1994.

AMERICAN SOCIETY OF CIVIL ENGINEERS

The American Society of Civil Engineers, founded in 1852, is the oldest national engineering society in the United States. Membership, held by 115,000 individual professional engineers, is about equally divided among engineers in private practice; engineers working for federal, state or local governments; and those employed in research and academia. The Society's major goals are to develop engineers who will improve technology and apply it to further the objectives of society as a whole, to promote the dedication and technical capability of its members and to advance the profession of civil engineering.

AMERICAN ASSOCIATION OF ENGINEERING SOCIETIES

The American Association of Engineering Societies (AAES) is a multi-disciplinary organization dedicated to advancing the knowledge, the understanding and the practice of engineering in the public interest. Located in Washington, DC, AAES includes 28 engineering and scientific societies with over 800,000 members in industry, government and education.

THE EMPLOYEE EDUCATIONAL ASSISTANCE ACT OF 1995

ASCE is a strong supporter of the bill introduced by Congressman Levin, H.R. 127, the Employee Educational Assistance Act of 1995 which would make Section 127 permanent. This bill currently has 87 co-sponsors. This legislation has always enjoyed strong bi-partisan support on both sides of Capitol Hill.

ASCE believes reasonable educational assistance paid for by an employer should not be considered as additional employee income. ASCE supports exclusion of employer-paid educational assistance for undergraduate, graduate and continuing education courses from the employee's gross income for tax purposes. Currently, Section 127 allows employers to provide up to $5,250 per year to each of their employees in tax-free reimbursement for tuition, books and fees for non-job or job related education. Key benefits of Section 127, which was first enacted in 1978, are the reduced administrative inequities and tax code complexities associated with not having to determine whether certain educational or training courses are job-related. For example, a civil engineer with technical expertise in bridge design but in need of business or management training could use Section 127.

Over the years Section 127 has been allowed to expire, only to be subsequently reinstated (sometimes retroactively). On at least one other occasion the exclusion under Section 127 for graduate study costs was curtailed, which had a particularly harmful impact on our members. This unpredictable handling of Section 127 by the Federal Government has caused confusion among employers and employees, and has tended to discourage rather than promote employer-paid educational assistance.

The economic vitality and global competitiveness of the United States are critically dependent upon a highly trained technical work force. Graduate and continuing education for the American civil engineering work force is not a luxury, but rather an essential element of professional practice. Keeping pace with new and expanding fields of technology demands on-going education if America is to successfully meet the new reality of intense global competition. Our members are committed to life-long learning. The Seventh Fundamental Canon of ASCE's Code of Ethics states: "Engineers shall continue their professional development throughout their careers, and shall provide opportunities for the professional development of those engineers under their supervision".

Another facet of this issue is the need to produce quality educated engineers who can compete with foreign engineers since it is the policy of foreign governments and employers to send their students to U.S. universities where foreign students now constitute more than half of the graduate student body in many technical fields.

Extension of Section 127 is also important because:

- For many Americans, employee educational assistance benefits are the only way they can obtain a college or graduate-level education.

- The program is a proven one. According to the American Society for Training & Development (ASTD), since 1978 more

than seven million Americans have been able to work and attend classes in order to improve their skills and qualify for better jobs.

- This program is of special importance to women and minorities, as well as to workers who are at the bottom of the career ladder and who need better skills in order to move up.

- Section 127 benefits are used by employers to retrain workers either for other work within the company or, in the case of layoffs, for other employment in the community.

Contrary to the perception of some people, Section 127 does not confer disproportionate benefits on higher-paid workers. According to an analysis of the Department of Education's National Post-Secondary Student Aid Survey by Coopers & Lybrand in 1989, Section 127 benefits appear to be distributed in a manner closely paralleling earnings among the labor force as a whole. Benefits did not accrue disproportionately to higher-paid employees. Nearly 99% earned less than $50,000, 71% less than $30,000 and 35% less than $20,000.

Civil engineers, despite meeting rigorous educational standards, are not among the most highly compensated professionals when compared to other professions. ASCE research reports that the average starting salary for civil engineers was $32,000 in 1993. Mid-career civil engineers with Master's degrees or engineering licenses received salaries averaging $50,000 - $58,000 in 1993. Some may ask: "What kinds of courses are Section 127 recipients likely to take?" Again, referencing the Coopers & Lybrand study, nearly half of those with identified majors who were using Section 127 benefits were taking business-related courses. The remainder were taking, in descending order, courses in engineering, health science/nursing, education and computer science.

Another important consideration for Congress is the revenue loss associated with the tax exclusion for employer paid educational assistance. The most recent Joint Committee on Taxation (JCT) cost figure was the $545 million estimate for an 18 month extension that was generated in 1993. We expect that a new JCT cost estimate will be forthcoming. The JCT cost estimates for Section 127 have varied considerably over the years. Whatever the relatively modest cost to the U.S. Treasury associated with Section 127, ASCE strongly believes that the benefits to society far outweigh the cost.

Madam Chair, on behalf of ASCE and the AAES, thank you for allowing me to appear before the committee today. I would be happy to respond to any questions.

Mr. HERGER. Thank you very much, Mr. Thornton.
Mr. McVey, please.

STATEMENT OF ROSS J. MCVEY, ASSISTANT CONTROLLER AND DIRECTOR, TAX OF TELEPHONE & DATA SYSTEMS, INC., MIDDLETON, WISCONSIN

Mr. MCVEY. Good afternoon. My name is Ross McVey. I am the assistant controller and director of Tax of Telephone and Data Systems, or TDS. We welcome and appreciate the opportunity to provide testimony in support of the permanent addition of the exclusion for employer-provided educational assistance.

TDS is a diversified telecommunications company providing telephone, cellular telephone, and radio paging services in 37 States throughout the United States. TDS provides these services through its three subsidiaries, TDS Telecom, United States Cellular Corp., and American Paging. These subsidiaries have operations in approximately 225 business locations. While the TDS family employs over 5,000 people, a majority of these individuals are working at a typical small business located in rural America.

TDS's continued expansion into new markets, combined with the technological advances in the telecommunications industry and with increased competition, place greater demands on our company and our employees. The continued success of TDS depends, in large measure, on a well-educated and well-trained work force.

A hallmark of TDS has been its investment in the continuing education and training of its employees. To this end, TDS maintains an employer-provided educational assistance plan.

During 1994, TDS spent over $500,000 in educational assistance. The exclusion from income and payroll taxes of employer-provided educational assistance payments benefits the employee, the employer, as well as the Nation.

A well-educated and well-trained work force is vital to the Nation. We must strive to be a leader, a leading competitor in the global economy. The need for highly skilled employees will continue to increase in the information age. As more of the Nation's citizens move into professional and technical careers, our standard of living will increase.

For these reasons, education should be a top priority of the government. We believe that the investment the government makes now will be recouped many times over in the life of an individual.

The educational assistance program has been a valuable asset to TDS. The educational assistance program at TDS helps to increase employee loyalty, morale, and productivity. We believe that a well-educated and well-trained employee is more flexible and can adapt quicker to a changing business environment. This is important to TDS as we reorganize and modify our operations to meet customer demands.

In addition, the technological changes in the telecommunications industry will require our employees to pursue educational and training opportunities not only within their chosen field, but also in other areas that affect TDS.

The employee benefits in several ways from an employer-provided educational assistance program. Often, this is the only fi-

nancial assistance available. A full-time employee generally is not eligible for traditional forms of student aid.

In addition, the opportunities for advancement are much greater when an employee completes their bachelor's degree or obtains an advanced degree. The educational assistance will allow an employee to complete their education much sooner than if the employee were to finance the full cost of their own education. Currently in my department, 35 percent of the employees have either been accepted into a graduate program or are working on an advanced degree.

The repeal of the exclusion from income of employer-provided educational assistance payments would significantly hamper continued improvements to the American work force by adding considerable cost to both the employee and the employer in terms of income and payroll taxes.

The exclusion from income of employer-provided educational assistance under section 127 of the IRC was first enacted in 1978. The provision was originally set to expire in December of 1983. Subsequent to that, the provision has been extended at least six times.

While recognizing the budgetary constraints that are pervasive throughout tax legislative changes, the temporary status of this provision only helps to reduce the efficiency of congressional activity.

To summarize, TDS strongly advocates the permanent adoption of the exclusion from income of employer-provided educational assistance. An educational assistance program benefits the employee, the employer, and the Nation.

We would like to stress that for many of our employees, an educational assistance program is the only means of obtaining a higher education in a reasonable amount of time.

I thank you very much for the opportunity to present TDS's views here today.

[The prepared statement follows:]

Testimony of Ross J. McVey

on Behalf of
Telephone and Data Systems, Inc.

Concerning Extension of IRC Section 127

Good morning, my name is Ross J. McVey and I am the Assistant Controller and Director - Tax of Telephone and Data Systems, Inc. or TDS. We welcome and appreciate the opportunity to provide testimony in support of the permanent addition of the exclusion for employer provided educational assistance to the Internal Revenue Code. TDS is a diversified telecommunications company, headquartered in Chicago, Illinois, providing telephone, cellular telephone, and radio paging services in 37 states throughout the U.S. and the District of Columbia. TDS provides these services through its three subsidiaries, *TDS Telecom, United States Cellular Corporation, and American Paging, Inc.* The subsidiaries have operations in approximately 225 business locations. So while the TDS family employs over 5,000 people, a majority of these individuals are working at a typical small business located in suburban and rural America.

TDS's continued expansion into new markets combined with the technological advances in the telecommunications industry and with increased competition place greater demands on our company and our employees. The continued success of TDS depends in large measure on a well educated and well-trained workforce. A hallmark of TDS has been its investment in the continuing education and training of its employees. To this end, TDS has maintained an employer-provided educational assistance plan for the past several years. Since 1993, TDS has spent over $500,000 in educational assistance. The exclusion from income and payroll taxes of employer-provided educational assistance payments benefits the employee, the employer, as well as the nation.

A well-educated and well-trained work force is vital to the nation. We must strive to be a leading competitor in the global economy. The need for highly skilled employees will continue to increase in the information age. As more of the nation's citizens move into professional and technical careers, our standard of living will increase. For these reasons, education should be a top priority of the government. We believe that the investment the government makes now will be recouped many times over in the life of an individual's career.

The educational assistance program has been a valuable asset to TDS. The educational assistance program at TDS helps to increase employee loyalty, morale, and productivity. We believe that a well-educated and well-trained employee is more flexible and can adapt quicker to a changing business environment. This is important to TDS as we reorganize and modify our operations to meet customer demands. In addition, the technological changes in the telecommunications industry will require our employees to pursue educational and training opportunities not only within their chosen field, but also in other areas that affect TDS.

The employee benefits in several ways from an employer-provided educational assistance program. Often, this is the only financial assistance available. A full-time employee generally is not eligible for traditional forms of student aid. In addition, the opportunities for advancement are much greater when an employee completes his bachelor's degree or obtains an advanced degree. The educational assistance will allow an employee to complete his education much sooner than if the employee were to finance the full cost of his education. Currently in my department, 35 percent of the employees have either been accepted into a graduate program or are working on an advanced degree.

The repeal of the exclusion from income of employer-provided educational assistance payments would significantly hamper continued improvements to the American work force by adding considerable costs to both the employee and the employer in terms of income and payroll taxes. Section 162 of the Internal Revenue Code, in its present form, allows an employee to deduct from income amounts incurred for education or training which maintain or improve skills in his present position or meet the express requirements of his employer. The educational expenses are not deductible if the education qualifies the employee for a new trade or business. Additionally, the employee may deduct the expenses only if he itemizes deductions and the educational expenses combined with other miscellaneous deductions exceed two percent of his Adjusted Gross Income (AGI). Expenses paid for by the employer may be excluded from income of the employee as a working condition fringe benefit under Section 132 if the education or training is work related as defined in Section 162. Much of the course work undertaken by employees at TDS would not qualify under Sections 132 and 162 because the education would qualify them for another trade or business.

The exclusion from income of employer-provided educational assistance under Section 127 of the Internal Revenue Code was first enacted in 1978. The provision was originally set to expire on December 31, 1983. Subsequent to that date, the provision has been extended seven times. The latest extension expired on December 31, 1994. The temporary nature of this provision adds needless complexity and time to both Congressional and business activities. Each of these expirations required Congressional review and analysis. While recognizing the budgetary constraints that are pervasive throughout tax legislation changes, the temporary status of this provision only helps to reduce the efficiency of Congressional activity.

The continuing expiration and extension of this provision have a negative impact on business as well. This additional burden is best illustrated by the most recent extension of the provision after it expired on June 30, 1992. The exclusion of employer-provided educational assistance was then retroactively reinstated for taxable years beginning after June 30, 1992 as part of the Omnibus Reconciliation Act of 1993. Therefore, companies that had followed the existing tax law and treated such assistance as taxable income for amounts paid in the last half of 1992, were required to handle the administrative burden created by the reinstatement of this exclusion in the following year. The typical small business did not and does not have the staff or specialized knowledge to properly address this change. The result is that additional costs were incurred by businesses to ensure compliance with the tax law. To eliminate the additional time and complexity surrounding this provision, we strongly advocate the permanent addition of this exclusion to the existing tax law.

In conjunction with making this provision permanent, we urge Congress to index the cap on the exclusion. The limit on excludable benefits is currently $5,250. The cap was last increased as part of the Tax Reform Act of 1986. Tuition expenses for education have risen faster than the rate of inflation for the past several years. Between 1980 and 1993, the Consumer Price Index increased 75 percent. During the same period, tuition at public universities increased 207 percent and tuition at private institutions increased 220 percent. In order for the exclusion to remain effective, the cap should be indexed at least for the rate of inflation.

To summarize, TDS strongly advocates the permanent adoption of the exclusion from income of employer provided educational assistance. An educational assistance program benefits the employee, employer and the nation. Again, we would like to stress that for many of our employees, an educational assistance program is the only means of attaining a higher education in a reasonable amount of time. The benefits to TDS and our economy are a more competitive and adaptable work force. By making this provision permanent, both Congress and business save time and reduce costs. Indexing the cap on educational assistance will keep the exclusion meaningful if education costs continue to rise.

Mr. HERGER. Thank you very much, Mr. McVey.

Ms. Chase, you mentioned that you are, if I understood correctly, a product of this program and that it had helped you and enabled you to go on for further education and better yourself in your employment.

I guess my question would be, within your company, if section 127 were to be allowed to expire, how would you anticipate that that might influence your company as far as continuing to provide tuition assistance for other employees as you were able to?

Ms. CHASE. I am afraid that it becomes another more administrative burden. In human resources, we are trying to balance such things as COBRA and such things as Family Medical Leave Act. We have State law to follow. We have Federal law to follow. I don't think that it would go away, but I think that we would have to gear up to just handle the administrative burden that would be associated with that if it was handled differently.

Does that answer your question?

Mr. HERGER. More or less.

Do you feel your company would continue? Do you think there might be a possibility that your company or others might, perhaps, be cut because of that?

Ms. CHASE. I believe we would continue, but it would be another point I would have to sell to my CEO. Yes, but I do believe it would continue.

Mr. HERGER. OK. During good times, if your company is doing well, obviously that would be something you would do. Perhaps, if times were a little bit tougher, that might be an area that could be done away with.

Ms. CHASE. It could be cut.

Mr. HERGER. Mr. McVey, I understand you have a company in the Happy Valley of California.

Mr. MCVEY. Happy Valley, California. Yes, sir. I certainly do.

Mr. HERGER. It is good to have you with us.

Mr. MCVEY. We have 23 employees in the State of California, and 2 of them are currently engaged in the continuing education program. Two of your constituents would be directly affected by this program.

Mr. HERGER. I appreciate you letting me know that.

If section 127 were allowed to expire, a deduction for some job related education expense would be permitted, subject to the floor on miscellaneous itemized deductions under section 162. What would be the administrative burden associated with determining whether education expenses are job related?

Mr. MCVEY. At the present time, we are trying to go through that in order to comply with the law as it currently reads, and it is a particularly burdensome task to have to go through and figure out whether 5,000 employees are or are not in school and get them to send us a copy of their class list and try to decide whether that particular course is job related based on their job description.

Admittedly, there are some times when you simply guess. The reinstitution of section 127 would relieve us of that particular burden. It will eliminate future controversies with the Internal Revenue Service when they come back to do an audit, and that can only benefit both sides.

Mr. HERGER. Thank you very much.

Mr. Levin will inquire.

Mr. LEVIN. Thank you.

I think, Mr. Herger, your question on sections 162 and 127 is, indeed, a cogent one, and I think the answer is very helpful.

Let me just say I think all of your testimony was very helpful, and you added some increased evidence of the bureaucratic mess that is created by on-again-and-off-again, and it would be much preferable if we could decide on a public policy and make it permanent, and I hope all of us will keep that in mind.

With both your personal stories, and across-the-board professional experiences, your testimonies have been illuminating.

Thank you very much.

Mr. HERGER. I thank this panel. With no further questions, we thank you for joining us.

If the next panel would step forward, please. Wayne Ashworth, president of Virginia Farm Bureau, Richmond, Virginia, on behalf of the American Farm Bureau; John Young, president of the National Council of Agricultural Employers; Abbey Meyers, president, National Organization for Rare Disorders; Lisa Raines, vice president, government relations, Genzyme Corp.; James A. Joseph, president and chief executive officer, Council on Foundations; Jesse J. Thompson, founder, Provident Benevolent Foundation; and Joseph A. Licata, vice president of employee benefits, Salomon Brothers.

Mr. Ashworth, if you would present your testimony, please.

STATEMENT OF C. WAYNE ASHWORTH, PRESIDENT, VIRGINIA FARM BUREAU, RICHMOND, VIRGINIA; ON BEHALF OF THE AMERICAN FARM BUREAU FEDERATION

Mr. ASHWORTH. Yes, sir. Mr. Chairman and Members of the Oversight Subcommittee, I want to thank you for the opportunity to appear before you today representing the American Farm Bureau Federation.

I am Wayne Ashworth, president of the Virginia Farm Bureau. The Virginia Farm Bureau represents more than 114,000 member families. I have been involved in the Farm Bureau in one capacity or another since 1963. The American Farm Bureau is the Nation's largest general farm organization. The Farm Bureau has members in all 50 States and Puerto Rico, representing some 4.4 million member families nationwide. Farm bureau and ranch members are engaged in the production of virtually every agricultural commodity grown commercially in the United States.

I am here to present the views of the AFBF, American Farm Bureau Federation on the Federal Unemployment Tax Act (FUTA), and unemployment insurance (UI), coverage of temporary aliens agricultural workers admitted to the United States under the H2–A Program

When the UI Program was created, agricultural employers were exempt. In 1976 the Federal law was changed to extend eligibility to employees of certain agricultural employers. When UI coverage was extended to agricultural workers, payroll taxes were likewise extended to the employers. Temporary alien workers were exempted from FUTA taxes.

Workers under the H2–A Program are admitted to the United States to work for limited periods of time and are employed across the United States. They work in tobacco, apples and vegetables in my home State of Virginia and in the States of Kentucky and Tennessee. They work in tobacco and vegetables in North Carolina. They work in fruit, vegetables and nursery crops in New England and New York. They are employed in sheep herding in 12 western States, including North Dakota, South Dakota, Wyoming, Montana and California.

The policy resolutions adopted by the elected voting delegates of the member State Farm Bureaus at the 76th annual meeting of the AFBF, in January 1995 specifically addressed the issue of FUTA coverage for H2–A workers and opposed the imposition of Federal unemployment insurance payroll taxes on H2–A employers. The Farm Bureau policy is clear in its opposition to extending UI to H2–A workers and request that the H2–A FUTA exemption be extended permanently.

There are several reasons why UI should not be extended to H2–A workers. H2–A workers must return to their home countries at the conclusion of their employment and cannot remain unless they have secured additional employment with an H2–A certified employer. Due to their immigration status as temporary alien agricultural workers, H2–A workers are unable to meet the statutory unemployment eligibility test of being willing, able and available to work.

To force employers of H2–A workers to pay into the UI system would only serve to undermine the insurance feature of the program. In effect, employers would be forced to pay for insurance protection for their employees against financial loss associated with unemployment, despite the fact that no such injury can occur.

In addition, there is little in the way of additional revenue to the Federal Unemployment Trust Fund to be realized, if FUTA taxation is extended to the wages of H2–A workers. Employers are required to pay a FUTA tax of 0.8 percent on the first $7,000 an employee earns. This is taxable wage base. If 15,000 H2–A workers in any given year—in 1993, the U.S. Department of Labor certified 17,000 H2–A slots—earned as much as a taxable wage of $7,000, the employers' tax liability to the Federal Government under FUTA would be approximately $56 per worker. Therefore the total collected from the H2–A FUTA tax at the Federal level would be $840,000.

Extension of the FUTA to H2–A workers do not result in a tax windfall for the Federal Government, but does entail additional compliance requirements for farmers and ranchers. Employers would be responsible for significantly higher tax liability to State employment security agencies. Employees pay up to 6.2 percent of payroll for FUTA. 5.4 percent of that amount is paid to the States for the payment of benefits.

Imposition of the FUTA tax for H2–A workers would result in yet another regulatory burden for farmers. Not only is there the direct cost of the FUTA tax to consider, but also the indirect cost of additional recordkeeping and reporting responsibilities.

For these reasons, Congress should make the H2–A FUTA tax exemption permanent. H2–A workers will never be able to meet the ready, willing and available test to receive benefits, even if taxes are paid for them.

I thank you for the opportunity to testify here today. If you have any questions, I would be willing to try to answer them.

[The prepared statement follows:]

STATEMENT OF THE AMERICAN FARM BUREAU FEDERATION

Presented by
C. Wayne Ashworth
President, Virginia Farm Bureau

Madame Chairman, members of the Oversight Subcommittee, I want to thank you for the opportunity to appear before you today representing the American Farm Bureau Federation. I am Wayne Ashworth, President of the Virginia Farm Bureau. Virginia Farm Bureau represents more than 114,000 member families. I have been involved in Farm Bureau in one capacity or another since 1963.

The American Farm Bureau is the nation's largest general farm organization. Farm Bureaus in all 50 states and Puerto Rico represent some 4.4 million member families nationwide. Farm Bureau's farm and ranch members are engaged in the production of virtually every agricultural commodity grown commercially in the United States.

I am here to present the views of the American Farm Bureau Federation on Federal Unemployment Tax Act (FUTA) and Unemployment Insurance (UI) coverage of temporary alien agricultural workers admitted to the United States under the H-2A program.

When the UI program was created, agricultural employers were exempt. In 1976, the federal law was changed to extend eligibility to employees of certain agricultural employers.

When UI coverage was extended to agricultural workers, and FUTA payroll taxes were likewise extended to their employers, temporary alien workers were also exempted from FUTA taxes.

H2-A workers are admitted to the United States under Section 101(a)(15)(H)(2)(a) of the Immigration and Nationality Act to perform agricultural labor tasks, generally for limited periods of time. H-2A workers are employed across the United States: they work in tobacco, apples and vegetables in my home state of Virginia, and in the states of Kentucky and Tennessee; they work in tobacco and vegetables in North Carolina; they work in fruit, vegetables and nursery crops in New England and New York; and they are employed in sheepherding in twelve western states including North Dakota, South Dakota, Wyoming, Montana and California.

The policy resolutions adopted by the elected voting delegates of the member state Farm Bureaus at the 76th annual meeting of the American Farm Bureau Federation in January 1995 specifically addressed the issue of FUTA coverage for H-2A workers and opposed the imposition of federal unemployment insurance payroll taxes on H-2A employers.

Farm Bureau policy is clear in its opposition to extending UI to H-2A workers and requests that the H-2A/FUTA exemption be extended permanently. The H-2A/FUTA exemption has been granted for specified periods of time, usually two to three years. The most recent exemption expired on January 1, 1995.

There are several reasons why UI should not be extended to H-2A workers. H-2A workers must return to their home countries at the conclusion of their employment, and cannot remain unless they have secured additional employment with an H-2A certified employer. Due to their immigration status as temporary

alien agricultural workers, H-2A workers are unable to meet the statutory unemployment eligibility test of being willing, able, and available to work. To force employers of H-2A workers to pay into the UI system would only serve to undermine the insurance feature of the program. In effect, employers would be forced to pay for insurance protection for their employees against financial loss associated with unemployment, despite the fact that no such injury can occur.

In addition, there is little in the way of additional revenue to the federal Unemployment Trust fund to be realized if FUTA taxation is extended to the wages of H-2A workers. As I mentioned before, employers are required to pay a FUTA tax of 0.8 percent of the first $7,000 an employee earns (the taxable wage base). If 15,000 H-2A workers in any given year (in 1993, the U.S. Department of Labor certified 17,000 H-2A slots) earned as much as the taxable wage base of $7,000, their employers' tax liability to the federal government under FUTA would be approximately $56 per worker. Therefore, the total collected from the H-2A FUTA tax at the federal level would be $840,000. Extension of FUTA to H-2A workers does not result in a tax windfall for the federal government, but does entail additional compliance requirements for farmers.

Employers would be responsible for a significantly higher tax liability to state employment security agencies; employers pay up to 6.2 percent of payroll for FUTA, based on their experience rating; 5.4 percent of that amount is paid to the states for the payment of benefits. Thus, employers would be subject to a significant state tax liability for Unemployment Insurance (which would vary somewhat by jurisdiction) should Congress fail to correct the law to exempt H-2A wages from FUTA.

Imposition of the FUTA tax for H-2A workers would result in yet another regulatory burden for farmers. Not only is there the direct cost of the FUTA tax to consider, but also the indirect costs of additional record keeping and reporting responsibilities. These added costs for farmers, unlike most other business operations, cannot be readily recouped in the form of higher prices for farm commodities. Unfortunately, farmers do not set commodity prices, the marketplace does. When prices are low, all the farmer can do is withhold commodities from the market in hopes of a better price at a later date. With highly perishable commodities, a farmer is only able to withhold commodities from the market for a very short period of time, if at all. If farmers are unable to recoup the added cost of FUTA taxes, it is a direct hit on net farm income. For perishable crops, margins are already razor thin.

For these reasons, Congress should make the H-2A/FUTA tax exemption permanent. H-2A workers will never be able to meet the "ready, willing, and available" test to receive benefits, even if taxes are paid for them.

Thank you for the opportunity to testify. I look forward to answering any questions you may have.

Mr. HERGER. Thank you very much, Mr. Ashworth.
Mr. Young, if you would testify, please.

STATEMENT OF JOHN H. YOUNG, PRESIDENT, NATIONAL COUNCIL OF AGRICULTURAL EMPLOYERS

Mr. YOUNG. Mr. Chairman and Members of the Oversight Committee, I want to thank you for giving me the opportunity to testify before you today representing NCAE, the National Council of Agricultural Employers.

I am John Young, president of the National Council of Agricultural Employers, and executive director of the New England Apple Council, a member of NCAE. I am also the owner and operator of Mapadot Farm, an apple orchard in New Boston, New Hampshire. We rely on the H2–A Program to secure apple pickers for our annual harvests, as do most of the members of the New England Apple Council.

The National Council of Agricultural Employers is the only national association focusing solely on farm labor and immigration issues from the farm management point of view. Our membership includes agricultural employers in 50 States who employ approximately 75 percent of the agricultural work force in the United States. NCAE's members include farm cooperatives, growers, packers, processors and agricultural associations. NCAE represents virtually all of the more than 3,000 employers who use the H2–A temporary agricultural worker program.

The H2–A worker program is the program under which aliens are admitted temporarily to perform agricultural work in the United States. Employers only become eligible to use the H2–A program after the U.S. Department of Labor has certified that sufficient U.S. workers are not available to fill their jobs.

The H2–A aliens are admitted to work for a specific employer for the duration of a specific temporary or seasonal agricultural job such as apple harvesting in my own case. After the H2–A alien completes the work contract for which he was admitted, he is then required to return to his or her home country, unless the stay is extended to work on another H2–A contract.

The payrolls of H2–A aliens (then called H2) were exempted from FUTA taxes when the unemployment insurance coverage was first extended to agricultural employers in 1976. The H2–A workers, along with most other categories of nonimmigrant aliens, were excluded from UI benefits by the same legislation. Congress has regularly renewed the H2–A FUTA tax exemption, most recently through December 31, 1994.

The exemption of H2–A payrolls from FUTA taxes is entirely consistent with the "insurance" concept which is at the heart of the UI program. Even if H2–A workers were not statutorily excluded from UI benefits, they would nevertheless be ineligible to receive benefits because they cannot remain in the United States and meet the availability for work test once they leave the employ of the employer who petitioned for their initial admission or extension of stay. It is not reasonable to require employers to pay premiums to protect workers who are barred from receiving the benefit the premiums purchase. Congress should, in fact, make the FUTA exemp-

tion on H2–A payrolls permanent, as it did with the H2–A exemption from FICA taxes, for which the same rationale applies.

My fellow panelist has pointed out that the revenue that would be added to the Federal coffers, if this exemption is not continued, is very small, well under $1 million. The total added cost to the affected farmers of imposing this tax is not reflected in the Federal portion. Most State laws exclude from State unemployment taxes the same payrolls that Federal law excludes from Federal taxation. The added State UI tax burden that farmers would incur by ending this exemption is substantial. For many farmers, it would amount to an immediate increase of more than 6 percent in their payroll costs because of the high UI experience rating resulting from the seasonal nature of farm work.

It is sometimes argued that H2–A payrolls should be taxed, even though H2–A aliens cannot receive UI benefits, in order to equalize employers tax obligations for U.S. and alien workers or to preclude an incentive to employ aliens or to discourage employers from employing them. This argument fails on two grounds.

First, H2–A aliens are already very expensive, as reflected by the low level of use of the program—about 17,000 H2–A aliens employed nationwide in 1994. The range of benefits farmers are required to provide in job opportunities certified for employment of H2–A workers is substantially above that received by the average U.S. farm worker. Added to this is the substantial cost of transportation and housing of the H2–A. The high cost of the H2–A program is the reason most frequently cited by farmers for the current low use of the program.

Second, it is not the role of the unemployment insurance program to seek to "discourage" employers from employing H2–A workers, when sufficient qualified domestic workers are not available to fill employers' job opportunities.

This is particularly true, given that Congress has throughout the history of U.S. immigration law taken the position that provisions for the temporary employment of aliens are needed and are in the national interest. If the unemployment insurance program is expanded from an insurance-based program for compensating workers who have temporary periods of involuntary unemployment into a program for advancing other agendas, the very integrity of the system and the protections it affords to working men and women will be threatened.

I urge the Subcommittee and the Congress to permanently exempt the payrolls of H2–A workers from FUTA taxes retroactive to January 1, 1995. Thank you for your attention, and I will be happy to respond to questions.

Mr. HERGER. Thank you very much.

Ms. Meyers.

STATEMENT OF ABBEY S. MEYERS, PRESIDENT, NATIONAL ORGANIZATION FOR RARE DISORDERS, INC., NEW FAIRFIELD, CONNECTICUT

Ms. MEYERS. Thank you.

I am Abbey Meyers, president of the National Organization for Rare Disorders, which is known as NORD. We are a group of approximately 135 national voluntary health agencies concerned

about orphan diseases, and we worked together in the early eighties to help pass the Orphan Drug Act of 1983. This law has become one of the most successful Federal laws passed by Congress in the last 20 years. It has created financial incentives to entice pharmaceutical manufacturers into developing drugs that ordinarily have little commercial value.

One of these incentives is a tax credit which is 50 cents on every dollar a company spends to develop a drug for a rare disease. These drugs are sold to very small populations of people and they ordinarily would cost more to develop than they would make a profit once it is on the market. It allows companies to save 50 cents out of every dollar that they spend on clinical trials. It is an extraordinarily important law, but every few years this tax credit expires and then Congress has to determine when it is going to reauthorize the tax credit, and it is usually months to a year or more before this reauthorization occurs.

We would like to see the orphan drug tax credit made permanent in the Tax Code, because it would give certainty to companies who cannot now make a decision as to whether to invest in an orphan drug's development, if they do not know whether they are going to have the tax credit every year when the credit expires.

We also feel it is extremely important that they carry forward the tax credit, because many of the orphan drug companies are small pharmaceutical and biotechnology companies that are not yet profitable and, therefore, they cannot use the tax credit. They cannot sell it, they cannot trade it, and they cannot use it until they become profitable. If they could carry that credit forward to future years when they are profitable, it would help enormously, especially in the biotechnology field, where the most promising treatments for genetic diseases would be developed. It would really help to encourage other companies to get involved with orphan drug development.

Eventually, we would like to see that tax credit cover preclinical research, too, but it is most imperative now that we reauthorize this credit immediately to make sure that companies do not lose the credits that expired in 1994.

I also have to say that Japan passed an Orphan Drug Act last year. The European Union will be passing an Orphan Drug Act within the next 2 years. We have to stay competitive with these other countries and make sure that the incentives of the Orphan Drug Act are strengthened, because there will be a large amount of competition in the near future in this area, and orphan drugs are a very important export of the United States.

Thank you.

[The prepared statement follows:]

STATEMENT OF ABBEY S. MEYERS
PRESIDENT, THE NATIONAL ORGANIZATION FOR RARE DISORDERS, INC

Madam Chairman and Members of the Subcommittee:

Good afternoon, I am Abbey Meyers, President of the National Organization for Rare Disorders, Inc. (NORD). NORD is a national non-profit voluntary health agency that represents the 20 million Americans who suffer from over 5,000 rare diseases and disorders. NORD's membership includes 138 national voluntary health organizations and support groups dedicated to the identification, treatment and cure of rare "orphan diseases."

An orphan disease is a condition that affects fewer than 200,000 Americans. Hereditary diseases account for approximately 4,000 of these 5,000 little known diseases. Because so few people are affected by each disorder, the pharmaceutical industry is reluctant to develop drugs to treat such illnesses due to the limited potential for profit. However, combined together rare diseases affect an estimated 20 million people in the United States alone, clearly adding major financial burdens to our nation. More importantly, the absence of effective treatments for these ailments causes severe disability and needless death among our fellow Americans.

The Orphan Drug Act of 1983

When I first testified before Congress fifteen years ago, rare disease patients were literally being "orphaned" by doctors, researchers, and pharmaceutical firms, and even by our government. Since drug companies would not manufacture treatments, scientists were not interested in spending years researching compounds that may never make it to the market. In 1983, Congress passed the **Orphan Drug Act** aimed at solving the orphan drug dilemma. It provided economic incentives to entice pharmaceutical companies into developing drugs of "limited commercial value" to treat or cure rare diseases. Finally, millions of profoundly desperate patients were given the hope that they so critically needed.

The Act has been enormously successful. During the ten years prior to the enactment of the law, only ten orphan products were developed by the industry. In the twelve years since, approximately 600 orphan products have been designated by the Food and Drug Administration (FDA) and 111 have been approved for marketing.

The Orphan Drug Tax Credit

One of the major incentives of the Orphan Drug Act is a tax credit of 50 cents on every dollar that a company spends for clinical research to develop an orphan drug. This was seen as a very necessary and positive way to attract companies into this field of research and development. However, the tax credit has had a very limited impact for several reasons. First, it expires every couple of years -- forcing Congress to spend valuable time deciding whether or not to grant reauthorization, and if so, whether the credit should be made retroactive to the date when it expired. This is why we are here today. These recurring gaps in the very existence of the orphan drug tax credits bring a great deal of uncertainty to manufacturers who are already hesitant to launch expensive clinical trials. Furthermore, such an uncertain fate tends to scare away prospective investors who are needed to provide the start-up capital for this research.

Therefore, the National Organization for Rare Disorders, Inc. (NORD) recommends that the Orphan Drug Tax Credit be made permanent, or at least extended for another five years.

Another reason for the limited impact of the tax credit involves its narrow application. Many small companies that are not yet profitable cannot use the tax credit because it cannot be carried forward to a profitable year. Therefore, the companies which are best suited to develop treatments for rare genetic disorders, the biotechnology industry, very often cannot use the tax credit. It is important to note that just last month, the Director of the National Institutes of Health (NIH) submitted a report to the Senate, entitled "Gene Therapy on Hereditary Rare Diseases". This NIH report strongly contends that biotechnology and gene therapy are the areas of scientific research which offer the most promise for discovering safe and effective treatments for the vast majority of rare orphan diseases. Everyone agrees that it is wise to invest in research where the technology actually has the highest probability of succeeding. The ability of a small company to carry the orphan tax credit forward is just that -- a smart investment in the most promising research.

According to the Department of the Treasury, only $18 million was claimed during 1992 by the pharmaceutical industry in orphan drug tax credits. This relatively tiny sum was claimed mostly by large multinational companies. When we look at the big picture, this small amount claimed indicates how little they invested in orphan drug research. The lions share of orphan drug development is being performed by small pharmaceutical and biotechnology companies because they are willing to develop products that have smaller annual sales. We believe that the orphan tax credit should be restructured to provide these innovative companies (and their investors) with at least some degree of certainty about such important business ventures in the interest of the public health.

Therefore, the National Organization for Rare Disorders, Inc. (NORD) recommends that companies be allowed to carry the Orphan Drug Tax Credit forward to a profitable year.

A third reason the orphan credit has not shown greater results is because it may only be applied to the costs incurred for clinical research, in other words human trials. Essential pre-clinical trials -- such as expensive toxicology tests -- are not covered by the orphan credit. The U.S. National Commission on Orphan Diseases, in its 1989 report to Congress, recommended that the tax credit should be applicable to such pre-clinical testing.

Therefore, the National Organization for Rare Disorders, Inc. (NORD) recommends that the Orphan Drug Tax Credit be applied to pre-clinical research costs.

Madam Chairman, while others may offer further suggestions for the restructuring of the orphan drug tax credit, NORD does not. For example, we do not support the expansion of the tax credit to cover post marketing R&D. We believe that once a drug is approved and on the market and a company wants to study it for another orphan disease, then an orphan drug designation may be obtained for that new use. The tax credit would then apply to that new clinical research.

Anyone familiar with NORD's position on pharmaceutical issues throughout the years realizes that we do not shy away from criticizing the drug industry when necessary and we do not believe that the Orphan Drug Act is perfect. There have been a few problems. Three or four companies have developed drugs that have become extraordinarily profitable. We feel that these cases represent abuses of the intent of the law and we have recommended that Congress change the Act to prevent future abuses. However, that is a separate issue from the tax credits.

The fact is, more than 100 of the 111 orphan drugs on the market are **true** orphan products that have limited commercial value in comparison to drugs for prevalent diseases like arthritis or hypertension. Without orphan drug incentives, companies will choose to invest their limited resources in research and development of only the most profitable drugs for prevalent diseases. Orphan drugs on the market today include drugs for Wilson's disease, lead poisoning, dystonia, carnitine deficiency, porphyria and other diseases that have never been heard of by most people. Clearly, these treatments would not have been developed without the incentives of the Orphan Drug Act.

Madam Chairman, the National Organization for Rare Disorders celebrates one of the newest drugs to reach the market. Twenty years ago, academic scientists were studying a rare hereditary kidney disease, Cystinosis, which killed children during adolescence. They discovered that the drug cysteamine could prevent these children from losing their kidneys and going blind. Over the next two decades, the scientists searched for and indeed begged manufacturers to adopt this drug, but no company was interested because less than 300 children in the United States have Cystinosis. The scientists could not allow the children to die, so they continued to buy the raw chemicals and distribute cysteamine as an investigational drug. Periodically, they would run out of money and would have to beg and borrow in order to find the resources to keep the experimental treatment available. Finally, a generic drug company stepped forward and agreed to produce this treatment in a form which made FDA marketing approval possible. Today, children with the fatal hereditary metabolic disease, cystinosis, have been given a new life because the orphan drug, Cystagon, is now available from Mylan Pharmaceuticals.

Many more orphan drugs would be developed if manufacturers could rely on dependable tax credits that won't expire when they least expect it. Orphan drug development is an area where the government plays a vital role by meeting a societal need that is not being met by the private market. There is much more our government can do to alleviate suffering, and avoid disability and death if the orphan drug tax credit can be enhanced.

Madam Chairman, the United States is running the risk of falling behind in the highly competitive world of medical technology. By way of comparison, Japan enacted an Orphan Drug Act in 1994. During this first year, the Japanese have already approved 50 new rare disease protocols. The Japanese government subsidizes 50% of the cost of all research on all new orphan drug products, totaling several millions of dollars each year. Germany has reserved $840 million in an annual fund to support biotechnology research. Last year they solicited applications for funding of 30 gene therapy protocols, but they received 180 applications for those funds, mostly for rare genetic diseases. France allocated $50 million for gene therapy research last year, but the United States has reserved zero. The European Union (EU) has set aside $336 million for pharmaceutical R&D, encompassing nine priority areas (Article 20, Treaty of European Union). One of those priority areas is rare diseases. This year, the EU is drafting orphan drug legislation more expansive than ours -- with 10 years of market exclusivity and a wider definition of orphan status.

In our opinion, the Orphan Drug Act is the most significant piece of health care legislation in the last two decades. We are very pleased that the President indicated his support for the extension of the orphan drug tax credit in his FY'96 Budget Request to Congress earlier this year. We fully support the enactment of **H.R. 1566 "The Orphan Drug Tax Credit Amendments of 1995"**, recently introduced by Chairwoman Johnson and the ranking minority member of this subcommittee, Mr. Matsui. This legislation takes a first step in the right direction by 1) extending the tax credit permanently and 2) by allowing companies to carry the credit forward to a profitable year.

Madam Chairman, we appreciate having the opportunity to present our views before this Subcommittee. We offer our continued advice and support to you and your staff. Thank you.

Mr. HERGER. Thank you very much, Ms. Meyers, for your testimony.

Ms. Raines.

STATEMENT OF LISA RAINES, VICE PRESIDENT, GOVERNMENT RELATIONS, GENZYME CORP., CAMBRIDGE, MASSACHUSETTS; ON BEHALF OF BIOTECHNOLOGY INDUSTRY ORGANIZATION

Ms. RAINES. Thank you, Mr. Chairman.

My name is Lisa Raines and I am vice president of Genzyme Corp., a biotechnology company headquartered in Cambridge, Massachusetts. I am here today both on behalf of my company and the BIO, Biotechnology Industry Organization, which represents more than 570 biotechnology companies, State university centers and related organizations in 47 States.

Mr. Chairman, the biotechnology industry strongly supports enactment of H.R. 1566, Mrs. Johnson's bill to make the orphan drug tax credit permanent and to amend it so that the credit can be carried forward in the same way that the research and experimentation credit can be carried forward. This legislation will facilitate increased research into drugs to treat rare diseases for which no treatment is available, particularly by the small biotechnology companies that currently perform about half of all orphan drug research.

In the 10 years prior to the enactment of the Orphan Drug law, only seven drugs were approved by the Food and Drug Administration for treatment of rare diseases. In the 12 years since enactment, over 100 drugs have been approved for marketing, and about 600 are in various stages of development. This is concrete objective evidence of the success of the orphan drug program, perhaps one of the most clearly successful programs that Congress has enacted in the last 20 years.

My company Genzyme was the first and only company to develop an FDA, Food and Drug Administration, approved treatment for Gaucher disease, a severely debilitating and sometimes fatal genetic disorder with a worldwide patient population of under 5,000. We are now developing orphan drugs for a number of other rare diseases, including a variety of genetic diseases and rare cancers.

Still there is more research that needs to be done for the 20 million Americans that suffer from one of about 5,000 rare diseases. By reducing the risk and cost of developing treatments for millions of seriously ill Americans, the orphan drug tax credit plays an important role in creating an incentive for private companies to tackle these diseases.

Since the enactment of the orphan drug tax credit in 1983, it has been temporarily extended four times, most recently until December 31, 1994. It has since expired, thereby effectively increasing the cost of orphan drug research and reducing the incentive to developing orphan drugs.

The effectiveness of the tax credit to encourage the development of products that take 10 to 12 years to develop is compromised if companies cannot depend on it to last through the entire clinical development process. Uncertainty about the availability of the credit for the entire process has almost certainly led some compa-

nies to conclude that they cannot afford to develop orphan drugs. In the absence of these treatments, ineffective yet expensive health care interventions will continue to be a cost to the taxpayer.

H.R. 1566 would make the orphan drug tax credit permanent, and by reducing uncertainty about the net aftertax cost of orphan drug development, this legislation would better enable companies to financially commit themselves to the lengthy and arduous process of developing these products.

In fact, my company is prepared to make the following public commitment. If the orphan drug tax credit is made permanent, we will reinvest every cent of the tax savings attributable to the credit in orphan drug research. While no company can forecast its future circumstances or where scientific advances may take us, we do feel confident that we can keep this commitment for the foreseeable future.

In addition to making the credit permanent, we believe that the credit should be restructured as is provided in the bill to permit companies to carry the credit forward or back. Under the credit's existing structure, a company can only claim the credit if it has incurred corporate income tax liability in the same year as the credit is earned. It has to be used or lost that same year.

Of course, if the company loses money that year so it has no current tax liability, then it loses the credit forever. This is what happens to most biotechnology companies. It happened to my company for the first 10 years it was in existence. The last 2 years have been the first 2 that we have actually been able to use the credits that we have earned.

Restructuring the orphan drug tax credit to permit carryforward and carrybacks would also make it more closely resemble the research and experimentation tax credit on which it was modeled. Not only would such a restructuring increase consistency among two similar tax credits, it would eliminate the orphan drug credit's current discrimination against small development stage biotech companies at the same time as it increases the incentive for these companies to invest in orphan drug development.

Thank you for the opportunity to express the biotechnology industry's views.

[The prepared statement follows:]

STATEMENT OF LISA RAINES
VICE PRESIDENT FOR GOVERNMENT RELATIONS
GENZYME CORPORATION, CAMBRIDGE, MASSACHUSETTS

Madam Chairman and members of the Subcommittee, my name is Lisa Raines and I am vice president for government relations of Genzyme Corporation, a biotechnology company based in Cambridge, Massachusetts. I am here today on behalf of both Genzyme and the Biotechnology Industry Organization (BIO), which represents more than 570 biotechnology companies, state biotechnology centers, and related organizations in 47 states and more than 20 countries.

The biotechnology industry strongly supports enactment of H.R. 1566, a bill to make the orphan drug tax credit permanent and to amend it so that the credit can be carried forward in the same way that the research and experimentation credit can be carried forward. This legislation will facilitate increased research into drugs to treat rare diseases for which no current treatment is available, particularly by the small biotechnology companies that currently perform about half of all orphan drug research.

I am pleased to note that this bill is being offered on a bipartisan basis by the Chairwoman, Mrs. Johnson, and the ranking minority member of this subcommittee, Mr. Matsui. This legislation enjoys the support of both the patient and provider communities, it has no known opposition, it is consistent with the President's call on Congress to extend the orphan drug credit, and it would have a minimal impact on federal revenue receipts. The biotechnology industry urges swift enactment of the Johnson-Matsui bill.

Success of the Orphan Drug Legislation

The Orphan Drug Act is unanimously recognized as one of the most effective pieces of legislation enacted by Congress in the last twenty years. The Act provides a variety of incentives for companies to develop drugs with limited commercial potential to treat patients with rare diseases, which are defined by law as conditions affecting fewer than 200,000 Americans.

In the ten years prior to enactment of the orphan drug law, only seven drugs were approved by the Food and Drug Administration (FDA) for treatment of rare diseases. In the twelve years since enactment, over 100 drugs have been approved for marketing and approximately 600 drugs are in various stages of development.

My company, Genzyme, was the first and only company to develop an FDA-approved treatment for Gaucher disease, a seriously debilitating and sometimes fatal genetic disorder with a worldwide patient population of under 5,000. We are now developing orphan drugs for a number of other rare diseases, including genetic diseases (cystic fibrosis and Fabry disease) and rare cancers (myelogenous leukemia, thyroid cancer, and Kaposi's sarcoma).

Still, there is more research that needs to be done for the 20 million Americans that suffer from one of about 5,000 rare diseases. By reducing the risk and cost of developing treatments for millions of seriously ill Americans, the orphan drug tax credit plays an important role in creating an incentive for companies to tackle these diseases.

Orphan Drug Tax Credit Amendments (H.R. 1566)

Bringing a new drug for a rare disease from bench to bedside is a lengthy and expensive process which typically consumes ten to twelve years of research costing many millions of dollars. The effectiveness of a tax credit to encourage the development of such products is compromised if companies cannot depend on it to last through the entire clinical development process.

Since enactment of the orphan drug tax credit in 1983, it has been temporarily extended several times, most recently until December 31, 1994. It has

since expired, thereby effectively increasing the cost of orphan drug research and reducing the incentive for developing orphan drugs. Uncertainty about the availability of the credit for the entire clinical development process has almost certainly led some companies to conclude that they cannot afford to develop orphan drugs.

H.R. 1566 would make the orphan drug tax credit permanent. By reducing uncertainty about the net, after-tax cost of orphan drug development, this legislation would better enable companies to financially commit themselves to the lengthy and arduous process of developing orphan drugs. In fact, my company is prepared to make the following commitment: If the orphan drug tax credit is made permanent, we will reinvest every cent of tax savings attributable to the credit in orphan drug research. While no company can forecast its future circumstances or where scientific advances may take us, we feel confident that we can keep this commitment for the foreseeable future.

In addition to making the credit permanent, we believe that the credit should be restructured -- as is provided in H.R. 1566 -- to permit companies to carry the credit forward or back. Under the credit's existing structure, a company can only claim the credit if it has incurred corporate income tax liability in the same year as the credit is earned. If the company loses money that year, so that it has no current tax liability against which the credit can be offset, then the credit is lost forever.

Restructing the orphan drug tax credit to permit carryforwards and carrybacks would make it more closely resemble the research and experimentation tax credit, which can be "saved" and applied to a company's future tax liability. Not only would such a restructuring increase consistency among two similar tax credits, it would eliminate the orphan drug credit's current discrimination against small, development-stage biotechnology companies at the same time as it increases the incentive for these companies to invest in orphan drug development.

Most small biotech firms have yet to bring their first product to market. Until its first product receives FDA approval and begins generating revenues, a small company will generally be unprofitable. Since unprofitable companies have no current tax liability against which to utilize the orphan drug credit, these companies get no benefit from the credit. Yet some small biotech companies perform more orphan drug research than some large pharmaceutical companies that have tax liabilities against which to offset their credit. Restructuring the credit would eliminate this tax inequity between large and small companies, while providing both with an important incentive to include orphan drugs in their research portfolios.

Making the tax credit permanent and restructuring it so that the credit can be used in tax years other than the one in which it was earned has been scored by the Joint Committee on Taxation to cost $157 million over the next five years. Such an amount is a small investment to provide an incentive for research that can be so effective in improving the quality of life of so many.

Other Proposals for Restructuring the Orphan Drug Tax Credit

While the biotechnology industry supports enactment of H.R. 1566 as drafted, we would like to encourage you to consider the addition of two additional restructuring proposals.

First, the credit could be made available for preclinical research, which is the laboratory and animal research that necessarily precedes human testing. Such preclinical research is fundamental to the discovery process of orphan drugs. As currently structured, the credit only applies to clinical (human testing) research.

And second, the credit could be made available for orphan drug clinical research that is conducted after the product receives FDA approval. Contrary to popular belief, clinical research does not end when a product is approved for marketing. For example, companies typically continue to conduct clinical trials to better understand the effect of different dosing regimens. In addition, FDA strongly encourages companies to conduct pediatric clinical trials with approved drugs so that they can be dosed appropriately for children. Similarly, a drug that is approved to treat one form of cancer may be tested against a second type of cancer. As currently structured, none of these post-approval clinical trials would be eligible for the credit.

Conclusion

Madam Chairman, I thank you for inviting me to testify before this Subcommittee. I would be happy to answer any questions.

Mr. HERGER. Thank you for your testimony.
Mr. Joseph.

STATEMENT OF JAMES A. JOSEPH, PRESIDENT AND CHIEF EXECUTIVE OFFICER, COUNCIL ON FOUNDATIONS

Mr. JOSEPH. Mr. Chairman, I am James A. Joseph, president and chief executive officer of the Council on Foundations. The council is a nonprofit charitable membership association of grant-making foundations and corporations. Our members number almost 1,400. Together they hold the bulk of the assets of the foundation community and make the bulk of that community's charitable grants each year.

I am pleased to testify today in support of permanent restoration of the highly important tax provision enacted in 1984 and sunsetted at the end of last year which permitted living donors to deduct the full value of publicly traded stock given to private foundations. Our experience strongly suggests that if the deduction is not restored, this critically important class of charitable giving will virtually disappear.

America's private foundations contribute more than $10 billion annually to charitable organizations large and small that advance scientific and medical research, strengthen the American educational system, help the poor and disadvantaged, and provide disaster relief, to name just a few of the multitude of charitable purposes of foundation grants.

Mr. Chairman, I have attached to my statement a document we call "Philanthropy's Great Grants," which tells the story of several important uses of private foundation grants. The expired charitable deduction before the Subcommittee, if restored, will provide a powerful incentive for Americans to make permanent conversions to charitable use of stock now held solely for private and personal benefit.

I would like to briefly highlight five good reasons to restore this charitable deduction. First, with pending government cutbacks in spending, the importance of giving to private foundations is greater than ever. While foundations clearly do not have the capacity to replace the likely spending cuts, they can provide invaluable assistance in the coming transition. Now more than ever, it is important to stimulate giving to foundations.

The second reason is that the expired charitable deduction has proven effective in stimulating increased giving. When the full value deduction for gifts of publicly traded stocks to private foundations was reinstated in 1984, lifetime giving to foundations skyrocketed.

The third reason is that the public charitable benefit far outweighs any revenue losses. Reinstatement of this deduction will generate benefits to charitable enterprises and the public far greater than any estimate of its effect over the next several years can suggest.

The fourth reason, IRS and Treasury have reported no problems or evidence of abuse. From time to time, Congress has expressed concern about the potential overvaluation of gifts to charity. It is important to emphasize to this Subcommittee that the charitable

deduction under consideration here permits full value deductions only for gifts of publicly traded stock.

The fifth and final reason, restoring the deduction will accelerate charitable benefits and produce more effective new foundations. In sum, Mr. Chairman, restoring the charitable deduction for gifts of publicly traded stock to private foundations presents a rare opportunity to transform substantial wealth now held for personal purposes to a major resource permanently dedicated to the support of sound and creative charitable works. For this reason and many others, I strongly urge you to renew this deduction and to make it a permanent part of the IRC.

Thank you very much for this opportunity to testify before you.

[The prepared statement and attachments follow:]

Statement of

JAMES A. JOSEPH
PRESIDENT AND CEO
COUNCIL ON FOUNDATIONS

Madame Chair and Distinguished Members of the Subcommittee:

Good morning, I am James A. Joseph, President and CEO of the Council on Foundations. The Council is a nonprofit, charitable membership association of grantmaking foundations and corporations. Our members now number over 1,375. Together they hold the bulk of the assets of the foundation community and make the bulk of that community's charitable grants each year.

I am pleased to testify here today in support of permanent restoration of the highly important tax provision, enacted in 1984 and sunseted at the end of last year, which permitted living donors to deduct the full value of publicly traded stock given to private foundations.[1] With the expiration of that provision, donors may now deduct only the cost basis of such gifts of stock. Our experience strongly suggests that, if the deduction is not restored, this critically important class of charitable giving will virtually disappear.

The Unique Contribution of Private Foundations

America's private foundations contribute more than $10 billion annually to charitable organizations, large and small, that advance scientific and medical research, strengthen the American educational system, help the poor and disadvantaged, and provide disaster relief -- to name just a few of the multitude of charitable purposes of foundation grants.[2]

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1 Section 170(e)(5).

2 Attachment I to this statement, entitled About Foundations provides more data on the capacity and limitations of foundations and their role in the charitable sector. For simplicity, the references throughout this statement which mention giving to "private foundations" or to "foundations" are contributions to grantmaking, nonoperating private foundations which constitute the great preponderance of all private foundations. Different charitable deduction rules apply to contributions given to foundations classified as "operating" or "pass-through" private foundations.

Private foundations have made major improvements in American life throughout the 20th century. They have, for example, been responsible for:

... The Salk polio vaccine
... The pap smear
... The cure for yellow fever
... Sesame Street
... The Emergency 911 response system

I have attached to my statement a document we call Philanthropy's Great Grants which tells the story of these and several other important uses of private foundation grants.[3]

The expired charitable deduction before the Subcommittee this morning -- if restored -- will provide a powerful incentive for Americans to make permanent conversions to charitable use of stock now held solely for private and personal benefit.

FIVE GOOD REASONS TO RESTORE THIS CHARITABLE DEDUCTION

#1-- With Pending Cutbacks in Government Spending, the Importance of Giving to Private Foundations Is Greater Than Ever

Foundation giving at roughly $10 billion a year is small in comparison to total U.S. charitable giving of over $120 billion or in comparison to a $1.5 trillion federal budget. Yet foundations are uniquely structured to readjust priorities, accommodate to change and refocus their support on emerging needs. The genius of foundations is to be found in the quality of their grantmaking rather than in the quantity of their resources.

Changes in governmental funding will -- of necessity -- force many American charities to reassess their capacity to respond. Such charities, both new and well-established, benefit greatly from being able to look to private foundations for assistance in going through such a transition. Because of their independence, foundations can provide the "research and development" funds for new and more efficient modes of coping with the problems that will confront these charities. Equally important, foundations have already proven themselves adept at working with government to streamline service delivery and discover cost-effective alternatives to traditional approaches. The heightened budgetary pressures on government will greatly increase the need for such work.

In short, while foundations clearly do not have the capacity to replace the likely spending cuts, they can provide invaluable assistance in the coming transition. Now, more than ever, it is important to stimulate giving to foundations.

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3 Attachment II.

#2 -- The Expired Charitable Deduction Has Proven Effective in Stimulating Increased Giving

Going well beyond the reforms recommended by Treasury in 1965, the Tax Reform Act of 1969 -- for the first time -- limited to the donor's cost basis the amount of charitable deduction that could be claimed for gifts of appreciated property to private foundations. The impact on lifetime giving to private foundations was devastating. Data compiled by The Foundation Center indicates that the rate of formation of new private foundations in the 1970s dropped over 42 percent -- from an average of 137 per year in the 1960s to 79 per year in the 1970s.[4] There is uniform agreement among practitioners in the field that most of the foundations formed in the 1970s were by bequest -- non-bequest giving simply dropped dramatically.

The full value deduction for gifts of publicly traded stock to private foundations was reinstated in 1984. Lifetime giving to foundations rebounded. Indeed, the 1980s and early 1990s brought a sharp reversal of the experience of the 1970s -- and a substantial increase in the number of new private foundations formed. According to The Foundation Center, the average number of private foundations formed in the 1980s grew to 246 per year compared to only 79 per year in the 1970s. One state -- Michigan -- has already identified over 50 new foundations formed in the past six years with publicly traded stock. The impact of the restored deduction could hardly be clearer.

As the 10-year life of the deduction was nearing its end in 1994, the Council on Foundations received an unprecedented number of phone calls from all across the country. The callers were attorneys, accountants, estate planners and other professionals who all had numerous clients wanting to give publicly traded stock to private foundations. No data is yet available to measure the number of private foundations formed at the end of 1994 as the sun set on the deduction, but we know there were many.

We need not guess, then, at the effectiveness of the charitable deduction for encouraging contributions of publicly traded stock to private foundations. When full deductibility was not in effect, very few foundations were created during donors' lifetimes. When full deductibility was reinstated in the law, lifetime giving responded promptly and markedly. The full deduction has plainly proved its worth.

#3 -- Public Charitable Benefit Far Outweighs the Revenue Loss

The Joint Committee estimates that restoring this deduction will produce a revenue loss of $286 million over the remaining part of the current fiscal year and the next five years. If the capital gains tax reduction included in the House-passed Contract with American becomes law, the revenue loss would drop by more than half of that amount to $128 million.

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4 Foundation Giving (1994 Edition), p. 27. Figures are for foundations with $1 million or more in assets or making grants of $100,000.

If the Joint Committee's revenue loss numbers are accurate, donors will be contributing appreciated stock to foundations in excess of $1 billion over the period of the estimate -- or roughly $200 million per year on average. Those figures, however, considerably understate the benefit that charity will realize from the restored deduction in the intermediate and longer term.

Our experience indicates that donors who create private foundations during their lifetimes --- and see for themselves the year-to-year good that foundations can accomplish --- are far more likely to make substantial bequests to their foundations at death than are well-to-do individuals without this background. Often such bequests are very large. Some range into the hundreds of millions of dollars.

Hence, reinstatement of this deduction will generate benefits to charitable enterprises -- and the public -- far greater than any estimate of its effect over the next several years can suggest.

A recent report by The Foundation Center illustrates the classes of charitable activity we can expect these enlarged foundation funds to support:[5]

1992 Grants of Largest Foundations

Subject	Amount	Percent
Education	$1,346,910,000	25.4
Health	943,836,000	17.8
Human Services	847,256,000	16.0
Arts and Culture	674,525,000	12.7
Public/Society Benefit*	590,217,000	11.1
Environment and Animals	255,130,000	4.8
Science and Technology	214,697,000	4.0
International Affairs, Development and Peace	178,956,000	3.4
Social Science	142,901,000	2.7
Religion	114,546,000	2.2
Other	2,740,000	0.1
TOTAL	$5,311,715,000	100.0

[*Includes civil rights, community development and volunteerism]

5 The Center's report is based on data for 1992 (the latest year available) resulting from a survey of grantmaking by foundations representing 52 percent of all grant dollars.

4 -- IRS and Treasury Have Reported No Problems or Evidence of Abuse

From time to time Congress has expressed concern about the potential overvaluation of gifts to charity. It is important to emphasize to this Subcommittee that the charitable deduction under consideration here permits full value deductions ONLY for gifts of publicly traded stock. Other types of appreciated property which may be more open to overstatement are simply not included. Gifts of land, privately held stock, partnership interests, works of art and even bonds are not included. In short, a donor to a private foundation can make use of this provision only by giving away appreciated property for which there is a recognized value published in the newspaper on the day of the gift. Overvaluation is simply not possible.

More generally, over the past 25 years, private foundations have established an admirable track record of compliance with the stringent anti-abuse rules imposed on them by the 1969 Act. Yes, there are occasional abuses, as there are in any sector, but the Internal Revenue Service -- on the basis of three nationwide audits -- has found that private foundations are among the most conscientiously compliant groups under its jurisdiction.

The core reforms enacted in 1969 for private foundations have worked well to keep out those who would abuse the system. The Council on Foundations has consistently supported the basic structure of this stricter system of regulation.

#5 -- Restoring the Deduction Will Accelerate Charitable Benefits and Produce More Effective New Foundations

Even if this charitable deduction is not reinstated in the income tax law, some individuals will doubtless create foundations by bequests at death. That was the experience even during the 1970s. With bequests to foundations fully deductible for estate tax purposes -- as they have been ever since the advent of the estate tax -- that pattern of giving would naturally recur.

Waiting to give by bequest, however, is a pattern far less advantageous for charity than lifetime giving. It deprives charitable endeavors of the use they could have made of the resources during the lives of the donors. Experience shows that, with the income tax deduction in effect, many private foundations are created during the donor's 40s, 50s and 60s. When those gifts are postponed to the donor's death, many years of foundation distribution are altogether lost to charity. One can be speculative about the magnitude of the loss, but it must at least be very considerable.

A separate point underscores the desirability of encouraging lifetime contributions. It has also been our experience in working with new foundations that they succeed with far fewer missteps if they begin operations during the life of the donor and can be guided by him or her while they are growing, learning and developing experience with philanthropy. Again and again, as we work closely with family foundations, we see that donors who get personally involved in their foundations during their lives tend to involve their families and begin family traditions of ongoing charitable commitment and wise giving. More effective foundations and more altruistic family traditions result.

In sum then, restoring the charitable deduction for gifts of publicly traded stock to private foundations presents a rare opportunity to transform substantial wealth now held for personal purposes to a major resource permanently dedicated to the support of sound and creative charitable works.

For these reasons, I strongly urge you to renew this deduction and make it a permanent part of the Internal Revenue Code.

ABOUT FOUNDATIONS

What is a Foundation?

Foundations are nonprofit organizations that suppport charitable activities in order to serve the common good. They provide this support by making grants to other nonprofit agencies, or through operating their own programs. In some cases, such as scholarships and disaster relief, foundations may make grants to individuals. Education, public health, scientific research, the arts, social services, religious organizations and the environment are just a few of the areas in which foundations provide funding

Foundations are created with endowments--money given by individuals, families or corporations. They make grants or operate programs with the income earned from investing the endowments. While foundations are exempt from federal income tax, they pay an "excise tax" on their net investment income each year.

The Tax Code distinguishes between private grantmaking foundations, which generally make grants from endowment income, and public charities, which generally raise money from the public for various causes and then operate institutions or programs such as universities or hospitals. Both foundations and public charities may use the term "foundation" in their titles, but very different laws apply to the organizations.

Why are Foundations Unique -- What do They do Best?

The governing boards of foundations are not subject to public elections nor (in most cases) are they subject to the concerns of corporate shareholders. Since most foundations have permanent endowments, they do not need to raise funds each year from the public in order to continue their work. Freed from these constraints, foundations are perfectly positioned to act as the research and development arm of society.

In its 1965 Report on Private Foundations, the Treasury Department recognized the special nature of foundations by describing them as "uniquely qualified to initiate thought and action, experiment with new and untried ventures, dissent from prevailing attitudes, and act quickly and flexibly." Foundations reflect the innovative spirit of the individuals and corporations that endow them. They provide risk capital for new approaches to tackling social problems and can make long-term commitments to addressing community needs. To list just a few examples of their impact, private foundations were the impetus behind the development of the Salk polio vaccine, the beginnings of the Head Start program and the production of *Sesame Street*.

How Many Foundations are There?

According to the 1994 edition of *Foundation Giving*, published by The Foundation Center, there are over 35,000 private, community, operating and corporate foundations in the United States:

- 31,604 private independent foundations
- 1,897 private corporate foundations
- 353 community foundations
- 1,911 operating foundations

At least 75 percent of all foundations are small and unstaffed; they are run either by volunteer boards or professionals (bank trust officers or lawyers). There are fewer than 6,800 foundations that have more than $2 million in assets or make over $200,000 in grants, yet these foundations hold 91% of foundation assets and are responsible for 90% of all foundation grant dollars disbursed. Of these larger foundations, roughly one in four have paid staff.

How Much do Foundations Give Each Year?

Together, grantmaking foundations held over $175 billion in endowment assets and made grants totaling approximately $10 billion to charitable causes in 1992. Yet, this annual grant amount is only eight percent of the $124.3 billion that Americans contributed to charity in the same year. According to *Giving USA 1994*, published by the American Association of Fundraising Counsel, total private philanthropic giving in 1992 was (in billions of dollars):

--	Individuals	$ 99.18	81.4%
--	Bequests	8.15	6.7%
--	Independent & Community Foundations	8.64	7.1%
--	Corporate Foundations	1.60	1.3%
--	Direct Corporate Giving	4.32	4.8%
		$121.89	100%

What is the Capacity of Foundation Giving?

In virtually every significant area, foundations lack the resources to replace most government programs and, as noted below, the focus of foundations' grantmaking is often legally limited or directed by the donor. Total foundation grantmaking for 1992 is approximately equal to:

1) The annual budget for the National Institutes of Health
2) 20 percent of the amount (almost $53 billion) that the government spent on education, training, employment and social services in 1993,[1] and
3) Less than 10 percent of the $125 billion in government spending on Aid to Families with Dependent Children, food stamps and Medicaid.[2]

What Limits are there on Grantmaking Focus?

Governing boards of some foundations have broad discretion regarding the charitable causes to which foundation grants may be directed; other boards are sharply limited -- often legally -- by the mandate of the foundation donor. For example, some foundations are restricted to making grants only for medical research, for assisting artists or for scholarships. Many foundations must restrict their grantmaking to a specific geographic area.

Where Do Foundation Grant Dollars Go?

According to *Foundation Giving*, in 1992, foundation grant dollars were distributed as follows:

	% of Grant Dollars	% of Grants
Education	25	23
Health	18	13
Human Services	16	21
Art & Culture	13	15
Public/Society Benefit*	11	12
Environment & Animals	5	5
Science & Technology	4	3
International Affairs	3	3
Social Science	3	2
Religion	2	2
TOTAL	100%	100%

* "Public/Society Benefit" grants include those for community development, public affairs, civil rights, social action and voluntarism.

How Does Giving by Foundations Differ from United Way Campaigns and Direct Giving by Individuals?

Private, community and many corporate foundations have endowments and thus are free from the uncertainties, struggles and costs of annual fundraising campaigns. By prudently managing their investments, they are able to provide a steady source of funding from the income and growth of the endowments while striving to keep the value of the endowment even with inflation. Thus, when economic downturns reduce individual giving, foundations are often able to maintain their grant levels.

How Do Foundations Work with Government?

In addition to making occasional grants to government, several foundations have taken steps to collaborate with Federal, state and local governments to streamline service delivery and explore cost-effective alternatives to traditional social services. Foundations have provided a source of non-partisan expertise and a perspective that extends beyond one administration's time in office. Foundations stimulate institutional reform through studies and support governmental change by funding model projects that have the potential for replication.

For More Information

Legislative affairs contact: John Edie or Anne Babcock, Council on Foundations, 202/466-6512
Programs and policy contact: Lauren Cook, Council on Foundations, 202/466-6512
Media contact: Mary Braxton or Greg Barnard, Council on Foundations, 202/466-6512

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[1] U.S. Government Printing Office, **Budget of the United States Government Fiscal Year 1995 (1994)** 253.

[2] Pear, *Welfare Debate Will Re-examine Core Assumptions*, N.Y. Times, Jan. 2, 1995.

PHILANTHROPY'S GREAT GRANTS

The developments described here have touched the lives of nearly every American--and yet not many Americans would readily make the connection that foundation grants helped make them happen. Because foundations serve as society's research and development arm--by funding programs that explore new problem-solving approaches--much of value is learned from those foundation-funded experiments that don't work out as well as the wide-impact successes described here.

White Lines on the Highway

In the early 1950s, engineer-inventor Dr. John V. N. Dorr had come up with a "revolutionary highway theory." He postulated that at night and when it was rainy, snowy or foggy, drivers hugged the white lines painted in the middle of highways. Dorr believed this led to numerous accidents and that painting a white line along the outside shoulders of the highways would save lives.

Dorr convinced highway engineers in Westchester County, New York, to test his theory along a stretch of highway with curves and gradients. The decrease in accidents was dramatic, and a follow-up test in Connecticut had similar results. Dorr then used his own foundation, The Dorr Foundation of New York, to publicize the demonstration's results.

Although state funds are now used to paint white lines on the shoulders of this nation's highways, every person who travels in a motor vehicle is indebted to Dorr and his foundation for the implementation of this life-saving discovery.

Emergency 911

Dial "911" any time of day or night from any telephone in the United States, and an operator will spring into action to determine the type and location of the emergency, send appropriate personnel and equipment to the scene, and tell you what to do until help arrives. It is such an important safety net that 911 is often one of the first phone numbers parents teach their children.

Efforts to create a national emergency medical response system began in 1966, when the National Highway Safety Act authorized funds for ambulances, communications and training programs. These efforts were augmented in the early 1970s when the Robert Wood Johnson Foundation provided 44 grants in 32 states for regional emergency medical services--the largest sum of private funds ever allocated for this purpose. The foundation program demonstrated the concept of a regionalized, systematic approach. Following these grants the federal government stepped in and made a series of grants that resulted in today's nationwide 911 system.

The Pap Smear

Cervical cancer is one of the easiest cancers to treat, when caught early. Until the 1940s, however, there was no simple, inexpensive test for diagnosing this disease. During the 1940s, however, there was no simple, inexpensive test for diagnosing this disease.

Dr. George N. Papanicolaou first discovered that cervical cancer could be diagnosed, before a women presented any symptoms, in 1923. Although he reported his findings, pathologists dismissed them, unwilling to believe cancer could be detected in individual cells. Dr. Papanicoulaou later wrote, "I found myself totally deprived of funds for continuation of my research...At a moment when every hope had almost vanished, The Commonwealth Fund...stepped in." Support for Dr. Papanicolaou's highly speculative work proved crucial to the development and eventual acceptance of the Pap Smear--the basic and now routine diagnostic technique for detecting cervical cancer.

Invention of Rocketry

The development of rocket science was a necessary precursor to space exploration, of strategic importance to America, as well as satellite communications, which touches our lives today in innumerable ways. It was foundation money that permitted a scientist to develop the technology that helped this nation become the first to place a man on the moon.

After having built a rocket that could travel in a vacuum, physics professor Robert H. Goddard received a small grant from the Hodgkins Fund of the Smithsonian Institute to build a high-altitude version of it. He succeeded in 1926, when he launched a rocket that flew 41 feet in the air for 2.5 seconds. A subsequent launch caught the attention of neighbors, police and reporters--who considered his efforts a joke--and Harry Guggenheim. Guggenheim consulted with Charles Lindbergh on the feasibility of Goddard's ideas, and it was Lindbergh who persuaded Guggenheim's father, Daniel Guggenheim, to provide four-year's support for Goddard's work. Ultimately, the Daniel and Florence Guggenheim Foundation funded Goddard's work for 11 years.

"Sesame Street"

Every day, 75 percent of this nation's preschool children learn their ABCs, colors and numbers from a huge yellow bird, a frog, a garbage-can "grouch," and a host of brightly colored puppets--along with a few human actors--on "Sesame Street." The children who tune in have fun while learning the basic cognitive and social skills they need to make the transition from home to school. In an average week the show reaches 16 million viewers; it is the most widely viewed children's series in the world.

Although "Sesame Street" is self-supporting today, this was not always the case. During the early 1960s the National Education Association endorsed the idea of making preschool

Yellow Fever Vaccine

By the beginning of this century Boston and Baltimore had experienced a total of 50 yellow fever epidemics and Charleston, South Carolina; Galveston, Texas; the Mississippi Valley and New Orleans, Louisiana had lost tens of thousands of people to the illness. Victims were being buried day and night.

Beginning in 1915, the Rockefeller Foundation funded a 30-year, all-out effort to eradicate this disease. Foundation physicians and scientists travelled to the cities and jungles of South America and West Africa, where they set up on-site laboratories and investigated causes of the disease. Many Rockefeller researchers died of the fever during the course of their work, but in 1936, foundation efforts paid off with the development of the first successful yellow fever vaccine. More than 1 million people were vaccinated in 1938 (with a 90 percent success rate) and during World War II, more than 34 million doses were manufactured and distributed free to Allied governments and health agencies. In 1951, foundation scientist Dr. Max Theiler received the Nobel prize in medicine for his work on the yellow fever vaccine.

Polio Vaccine

It was only 40 years ago people that in this country and the world lived in fear of the deadly, crippling effects of polio. Just recently, in December 1994, the Pan American Health Organization announced that polio finally has been eradicated from the Western Hemisphere. The visions of people in iron lungs and heavy braces have been all but erased from this nation's memory because of the Salk vaccine developed by Dr. Jonas Salk in 1953.

Salk was able to establish and equip his virus laboratory, located at the University of Pittsburgh, because of a 1948 grant from the Sarah Scaife Foundation (later known as the Sarah Mellon Scaife Foundation). Other foundations also supported Salk's work, but it was the Scaife foundation that put up the initial risk capital and provided a followup grant two years later.

Public Libraries

Going to the local library and borrowing books for free is a privilege most Americans take for granted. Yet less than a century ago the idea of equal access to books and educational materials was revolutionary and controversial. It was the generosity and vision of one man, Andrew Carnegie, that created more than 2,500 libraries worldwide during the early 1900s.

Nearly every community that requested support from Carnegie or his foundation--Carnegie Corporation of New York--received it, and by the 1920s funds from Carnegie and his foundation had led to the construction of 1,679 public libraries in the United States alone. Today, these libraries, each a monument to the grand architectural style of the time, are an integral part of this nation's public library network.

education available to all children, but funds available within school budgets were not sufficient for such programs. In 1966, Carnegie Corporation of New York underwrote a feasibility study on the use of television for preschool education. Carnegie, along with the Ford and John R. and Mary Markle foundations and others then gave Children's Television Workshop grants to launch "Sesame Street."

The Hospice Movement

In the early 1970s, long-term care for the terminally ill was a frustrating and saddening experience for families. A group led by Florence Wald, dean of the nursing school of the Yale-New Haven Medical Center, asked foundations to fund a feasibility study on opening a hospice in New Haven, Connecticut.

Simultaneous support from the Van Ameringen Foundation, the Ittleson Family Fund and The Commonwealth Foundation assisted in establishing and staffing a hospice to care for 100 terminally ill patients in their homes as well as a 44-bed facility. This program became a model for hospital and home care of terminally ill patients and a training center for hospice workers.

World Hunger

In the 1960s, the threat of widespread starvation in developing nations was one of the most pressing issues facing world leaders. Developing nations lacked the resources for the large-scale food production required to feed their expanding populations. A collaboration betwen the Ford and Rockefeller foundations created research centers, which brought together scientists from around from around the world to develop improved varieties of wheat and rice.

Two centers, the International Rice Research Institute in the Philippines and the International Maize and Wheat Improvement Center in Mexico created new varieties of rice and wheat that greatly enhance yields. The results were astounding--where just a short time before experts had predicted famine, countries quickly became self-sufficient, providing food at a low cost. Called the Green Revolution, this effort to improve agricultural practices also led to more jobs and goods for trade.

Mr. HERGER. Thank you very much, Mr. Joseph.
Mr. Thompson.

STATEMENT OF JESSE J. THOMPSON, FOUNDER, PROVIDENT BENEVOLENT FOUNDATION, CHARLOTTE, NORTH CAROLINA; ACCOMPANIED BY ROBERT S. MARQUIS, KNOXVILLE, TENNESSEE

Mr. THOMPSON. Mr. Chairman, my name is Jesse J. Thompson. I live in Charlotte, North Carolina. I appreciate the opportunity to appear before you and the other Subcommittee Members.

I am very much concerned with the question of reenactment of section 170(e)(5) of the IRC. Both my family and I believe strongly in gifts to charity through private foundations. It is my hope that by sharing with you some of my experiences with private foundations, we can show some of the good which they can accomplish.

My family made its living in the coal industry and we were very fortunate. Through a combination of hard work and good luck, we built a successful business that employed hundreds of workers. We have not, however, ever forgotten where we came from.

As a family, we now wish to share our good fortune with people in the areas where our family built our business. We feel strongly that we have been blessed and we wish to share our blessings with the communities and the people in the communities who helped us. Through our private foundations, we hope to be able to give something back to the communities and the people in Tennessee, Kentucky and Virginia who made our success possible.

Shortly before his death in 1987, my father established the Thompson Charitable Foundation, a private foundation which, when completely funded, will hold assets in excess of $70 million. Since its inception, the Thompson Charitable Foundation has distributed millions of dollars to charities and public works in our region.

I would like to focus on three projects which I believe illustrate the contributions which private foundations can make to the public good.

Buchanan County, Virginia, is located in the heart of the coal country. The people of Buchanan County have relied upon wells for their water supply for generations. Not surprisingly, the quality of the water has been quite low. In 1991, with the aid of a $1 million contribution from the Thompson Charitable Foundation and a Federal grant, Buchanan County built a modern water supply connected to the John Flannagan Dam Reservoir. Most Americans take issues like their water supply for granted. Now the citizens of Buchanan County also can have that luxury.

Scott County, Tennessee, is a coal mining community located in Tennessee's Cumberland Mountains. Like many rural communities, its needs are generally underfunded and ignored because it lacks the political clout of larger more urban counties. With an average annual income of less than $12,000 per year, the people of Scott County must struggle to meet the needs of the community.

The problem manifested itself in Scott County's school buildings, which had deteriorated to the point where it was difficult for the children to get a good education. The Thompson Charitable Foun-

dation provided approximately $1 million of the funding needed to build and equip new schools.

The entire community gathered in support of this project and the partnership has proven to be an overwhelming success. Scott County now boasts a new elementary school and its high school and middle schools have been rebuilt and equipped with state-of-the-art equipment. The long-term results have been even more rewarding. These schools recently won the Governor's Award, which recognize the national level achievement of Scott County's students.

My father lost his wife and several friends to cancer. As a result of his personal experience, he became acutely aware of the strain placed on families who were required to travel across the country in order to get the specialized care that cancer treatment so often requires. His concern led to the establishment of the Thompson Cancer Survival Center in Knoxville, Tennessee. During the financially difficult early years of its existence, the Thompson Cancer Survival Center was dependent upon the Thompson Charitable Foundation for the funding needed for this project to which my father was so dedicated. My father ultimately died of cancer.

These are but three examples of the important work that private foundations help to make possible. There are many more. These examples not only demonstrate the type of projects to which private foundations contribute, but also show that private foundations are often the catalysts which change dreams to reality.

I have seen the positive impact that they can have, and I have created my own private foundation, the Provident Benevolent Foundation, in Charlotte, North Carolina. Unfortunately, I have not yet fully funded it. I want to continue funding it. In fact, I have been doing so with appreciated stock. Now that section 170(e)(5) is no longer in effect, as a practical matter, I am penalized for contributing to Provident Benevolent, rather than public charities.

Of course, you might say I still have the ability to give directly to public charities. Many worthwhile projects will find their way to a private foundation which public charities are not interested in. Private foundations have played an important role in the charitable giving network. They can continue to do so. In this time of concern with controlling government spending, both public and private foundations are instruments for help.

I invite you to visit the Thompson Charitable Foundation and the Provident Benevolent Foundation and see for yourself the good works in which they have participated. I urge you to reinstate section 170(e)(5) so that private foundations can continue to grow and to help individuals and communities in need.

Mr. Chairman, sitting directly behind me is Robert S. Marquis from Knoxville, Tennessee. He has been our family's attorney for 20 years. He is a tax attorney and he has helped several individuals set up foundations. He has with him today a statement supporting the reenactment of section 170(e)(5) and, with your permission, I would like to ask that his statement be submitted for the record.

Mr. HERGER. Without objection, so ordered.

Mr. THOMPSON. Thank you very much.

[The prepared statement follows:]

STATEMENT OF ROBERT S. MARQUIS

Attorney and Principal
McCampbell & Young, P.C.

**STATEMENT OF ROBERT S. MARQUIS
BEFORE THE SUBCOMMITTEE ON OVERSIGHT,
COMMITTEE ON HOUSE WAYS AND MEANS,
U.S. HOUSE OF REPRESENTATIVES,
on May 9, 1995**

Madam Chairman:

My name is Robert S. Marquis and I am an attorney practicing in Knoxville, Tennessee. I appreciate the opportunity to appear before you and the other SubCommittee Members. I am here to encourage you to reinstate § 170(e)(5) of the Internal Revenue Code, and to share with you my real world experience concerning its importance. The only evidence I intend to offer is based on my own personal experiences which I believe support my position.

As an attorney working in Knoxville, Tennessee, since 1973, my practice is devoted primarily to estate planning. As is common among practitioners in this area, I have worked extensively with charitable organizations, serving both as counsel and as a director of several private and public foundations. I am here on behalf of certain of my clients who have specifically requested me to testify before you concerning the reinstatement of § 170(e)(5). But I am also here in my capacity as both a member of the estate planning bar and as a concerned citizen. Without exception, both the clients and other practitioners with whom I have spoken share my concern regarding the singular importance of this statute to charitable giving in general and to charitable activities in our community in particular.

Greater Knoxville has a population of approximately 500,000. In our area, I have participated in the establishment of approximately a dozen private charitable foundations and have worked with several others. I think it important for you to understand how and why these private charitable foundations came to be created and how, at least in my experience, they are operated.

There is no precise demographic profile of the donor who desires to establish a private charitable foundation -- indeed, I once had a retired school teacher who wanted simply to establish a private foundation to finance the needs of underprivileged band members -- but I would have to say that most of the donors which whom I work are wealthy. Most have achieved high levels of success and the wealth which so often accompanies it. They recognize and appreciate their good fortune, and desire simply to give something back to the community and the people who provided them with the opportunity to succeed.

Private foundations usually bear a strong resemblance to their founders. Such individuals typically possess a strong work ethic and a fierce determination to accomplish their goals.

Thus, just as small businesses are often more responsive to the needs of the market, so too are private foundations often more attentive and more responsive to the needs of the communities they serve. As a result, the cost-effectiveness of private foundations is unique.

Since we live an era where public funds have grown increasingly scarce, and the resistance to tax increases is almost universal, the competition for these funds is fierce. Add to this mix the very real concern we all share with respect to both budget deficits and the national debt, and the need for, and importance of, charitable giving is readily apparent. Irrespective of the provisions of the Internal Revenue Code, some level of charitable giving will always take place. Nevertheless, we all recognize that the Internal Revenue Code creates a powerful incentive for Americans to increase their charitable giving. Conversely, common sense tells us, and my experience confirms, the expiration of § 170(e)(5) has created an equally powerful disincentive to their charitable giving.

To be blunt about it, private foundations have been eliminated as a lifetime planning option for many of our clients. While the economic issue here is fairly obvious, the psychological issue is not. I have observed first hand the special relationship which founders have with their private charitable foundations. That is, private foundations allow their donors to become actively involved in the charitable works to which their foundations contribute. This frequently stimulates the founder's desire to give even more to the foundation.

Remember also that the worthy causes to which we are all asked to contribute seem endless. Who among us hasn't invoked the defense "I gave at the office?" But the pool of wealthy donors is limited. Private foundations occasionally have returned the joy to charitable giving to our clients by providing both donor and donee with a common forum. There is a very real efficiency gain to be found here which should not be underestimated.

Finally, private foundations are required by the federal tax code to make distributions each year and public charities always reap the benefits. Our clients understand this, and now ask why we discriminate against private foundations. The answer escapes me. And let us not forget that a contribution to a private foundation is irrevocable; the charitable giving which the annual distributions of private foundations represent is not subject to an individual's change of mind.

These are practical realities. I know from my own experience that private foundations work, and that the ultimate beneficiaries of the reinstatement §170(e)(5)will be the communities they serve. And in a world of limited public resources, can we afford to discourage charitable giving?

Thank you for the opportunity to appear before you today.

Respectfully submitted,

Robert S. Marquis

Mr. HERGER. Thank you very much, Mr. Thompson. We certainly appreciate more than we can express the generosity of yourself, your father and your family. Certainly, that type of caring is the backbone of our country, and what a great example you are. Again, thank you.

Mr. THOMPSON. Thank you.

Mr. HERGER. With that, we will move to our last panelist, Mr. Licata.

STATEMENT OF JOSEPH A. LICATA, VICE PRESIDENT, EMPLOYEE BENEFITS, SALOMON BROTHERS, INC., NEW YORK; NEW YORK, ON BEHALF OF AMERICAN PREPAID LEGAL SERVICES INSTITUTE, NATIONAL RESOURCE CENTER FOR CONSUMERS OF LEGAL SERVICES, HOTEL TRADE ASSOCIATION OF NEW YORK, HOTEL TRADES COUNCIL, AFL–CIO PREPAID LEGAL FUND, AND LABORERS INTERNATIONAL UNION; ACCOMPANIED BY GERALD MANN, ADMINISTRATOR AND CHIEF COUNSEL, DISTRICT COUNCIL 37 MUNICIPAL EMPLOYEES LEGAL SERVICES PLAN, NEW YORK, NEW YORK

Mr. LICATA. Thank you, Mr. Chairman.

My name is Joseph Licata. I am vice president of employee benefits for Salomon Brothers, Inc. With me here today is Mr. Gerald Mann, administrator and chief counsel of District Council 37 Municipal Employees Legal Services Plan. His testimony is also submitted on behalf of the American Prepaid Legal Services Institutes, the National Resource Center for Consumers of Legal Services, the Hotel Trade Association of New York, and the Hotel Trades Council AFL–CIO Prepaid Legal Fund, and the Laborers International Union.

On behalf of the 7.6 million Americans who access employer provided legal services plans, I would like to thank you for the opportunity to submit testimony in support of restoring equity to this employer provided benefit by reinstating its favorable tax treatment.

While my employer Salomon Brothers may not immediately evoke thoughts of moderate income working families, in fact, over two-thirds of our employees or approximately 3,600 workers are middle-class workers of moderate means, for example, our clerks, support staff, secretaries, telephone operators and courier staff, to name a few. Virtually all of the employees who are enrolled in our legal benefits plan, over 600 in number are wage earners in the low- to middle-income salary range. As with AT&T, Raft, Proctor & Gamble, Sears and many other corporations, it is on behalf of these important members of our team that we urge Congress to restore equity to the tax treatment of this benefit.

The firms management at Salomon Brothers, while generally not electing to participate in our legal benefits plan, is satisfied with providing this benefit for the staff because it contributes to the well-being of these critical members of the firm and thus increases our firm's productivity as a whole. In limiting the stress associated with legal issues by allowing these employees access to legal advice, this benefit provides tremendous value to our work force.

We strongly support H.R. 540 introduced by Representative Charles Rangel to make permanent section 120 of the IRC, thereby restoring equity to the treatment of this employment benefit.

In light of the fact that this employment benefit is provided to and for working middle-class Americans, allowing for its favorable tax treatment coalesces well with the national clamor for middle-class tax relief.

Specifically, in terms of middle-class tax relief, reinstating the favorable tax treatment of this particular employee benefit provides tremendous value to the taxpayer for the cost, because it allows low- and moderate-income wage earners access to legal advice which they would not otherwise be able to afford.

Having access to legal advice represents to a moderate-income wage earner the difference between a swift favorable resolution of a problem and a stressful long-term morass with an unfavorable outcome. Tax relief that could provide such an enormous benefit to working families, a benefit to families' security, stability and financial situation, constitutes the highest possible rate of return on taxpayer investment.

Employer-provided group legal plans have time and again proven their value in extending low-cost legal advice to working Americans. The reality for middle-class wage earners is that they cannot afford the services of an attorney and thus cannot afford to obtain advice for issues relating to child support enforcement, adoptions, wills, landlord-tenant situations and consumer debt problems.

Employers are pleased to provide this important benefit, because it removes troubling legal distractions from their employees which, left unattended, limit the employees' productivity. As a result, legal benefits plans enjoy broad support from corporate, consumer, labor and insurance groups. Because it provides access to legal advice, this employer-provided benefit assists working Americans in avoiding the family disintegration and job disruption that can result from neglected legal issues.

Examples of the multilevel cost effectiveness of this benefit abound. A working mother seeking to enforce an order of child support gains access to the assistance of a lawyer through this legal benefits plan and avoids the need to rely on public assistance. A consumer debt problem without legal advice can lead to a garnished salary, an eviction, the loss of a job, and dependency on public assistance.

The relatively minor cost of providing this favorable tax treatment is repaid innumerable times by keeping the wage-earner focused on his/her job, keeping a family in housing and intact, and removing the threat to moderate-income workers to remaining self-sufficient. In the last two renewals of the legal plan at Salomon Brothers, the cost of our premiums has not increased for my firm.

Employer-provided legal benefit packages produce economies in both the purchase of legal services for a large group and in the delivery of these services at a reduced price. Such economies in the provision of legal representation for the needs of average working Americans dovetails well with other types of legal reform this Congress has adopted in the last few months. Because they provide a cost-effective approach, these employer-sponsored legal benefit

plans are in the best American tradition of pragmatic, voluntary group action to meet common needs.

In the last session of Congress, this bill enjoyed broad support among both Republicans and Democrats, with 220 Members signing on as cosponsors. Already this session, this bill has 31 cosponsors and a "dear colleague" letter has yet to be circulated. Speaker Gingrich himself was among the cosponsors of this bill last session and has voiced support of the bill again this session.

In summary, we would highlight that, without this benefit, low- and moderate-income wage earners would not have access to legal advice from the private bar, the consequences of which are severe impediments to the self-sufficiency of these working families. Restoring equity to the tax treatment of this benefit by placing it on an equal footing with other statutory fringe benefits is a goal worth achieving this session, given that this employer-paid benefit provides so many concomitant valuable advantages to working Americans.

As one aspect of middle-class tax relief, a high return on the cost of this benefit is realized for the millions of working Americans who gain access to critical legal advice through its operation. By promoting economies in the purchase and delivery of legal advice, this benefit constitutes an important facet of legal reform.

We respectfully urge the Subcommittee to act favorably on H.R. 540. Thank you, Mr. Chairman, for letting me speak on this issue.

Mr. HERGER. Thank you for your testimony, Mr. Licata.

Mr. Young, it has been argued that H2–A workers are less expensive to employ than U.S. workers. Your testimony is responsive to this question, do wages paid to H2–A workers count against the FUTA wage threshold, and just what does this mean?

Mr. YOUNG. Yes, Mr. Chairman. My statement was that the wages paid to H2–A workers are higher than wages paid to the average U.S. farm worker and that the program is not an expensive one. We are not using the minimum wage, but we are using what is called an adverse effect wage rate, which is substantially higher. In the case of New York and New England, it is based at $6.21 an hour in 1995.

But the wages of H2–A workers prior to the exemption expiring were counted in the base number. They counted toward reaching the threshold that are necessary, but they were not taxed.

Mr. HERGER. Thank you.

Mr. Ashworth, do H2–A workers tend to work for the largest or the smaller agricultural employers?

Mr. ASHWORTH. I think that it would probably be more the smaller farms, but not excluding large farms. In my experience of working H2–A workers, being a small farmer myself, it was a godsend to have this type of labor, and smaller farms I think probably benefit as much or more than the larger farms.

Mr. HERGER. Why is their a need for this?

Mr. ASHWORTH. The H2–A worker is not eligible for Federal unemployment, so it would not be fair to pay a premium or a tax per se on something that could not be collected. Being that when this job is over, the H2–A worker comes under contract, and when this job is completed, this person will return to their original home in their own country.

Mr. HERGER. In the past, the rationale for the FUTA tax exemption for H2–A workers is that this group does not collect unemployment benefits. To your knowledge, has there been any change in the status or treatment of these temporary agricultural workers that would suggest employers should now begin paying FUTA taxes?

Mr. ASHWORTH. I know of no change that would create a need for employers to pay this tax. The exemption expired at the end of 1994, and what we would ask is for it to be retroactive to January 1, 1995 permanently.

Mr. HERGER. Are there any other categories of labor upon which employers are required to pay FUTA employment taxes? Where the employees are not permitted to draw the benefits or the laborers are permitted to draw the benefits?

Mr. ASHWORTH. I am not aware of any.

Mr. HERGER. Thank you.

Ms. Raines, while all of us would agree that it makes sense to encourage the development of orphan drugs, there is a tension between the need to provide a credit that is meaningful and the need to minimize the cost to the Treasury. It is difficult to know whether a 50-percent credit strikes the appropriate balance. What would the level of the credit be to encourage the development of needed drugs without an undue loss to the Treasury under your estimation?

Ms. RAINES. Let me say first that the 50-percent credit which has been in effect for the last 12 years has had a significant impact in increasing the number of orphan drugs in development. Clearly, a bigger credit would encourage more and a smaller credit would encourage less. I think that people in business take that into account when calculating what is the anticipated cost of developing a product.

What you are going to do if you reduce the credit is reduce the likelihood of development of those products that are most marginal in terms of the potential of returning the investment that is made. Recognize, too, that these are very high risk investments, that 9 out of 10 drugs do not work and do not make it to the marketplace. Under those circumstances, the market dictates that you go after the drugs that are likely to make it to the marketplace, and that have big markets out there waiting for them. Clearly, you can ratchet the tax credit up or down and anticipate the effects to be different.

The cost of this credit is lower than the cost of any other credit that this Committee has had under discussion today. The Joint Tax estimate is under $170 million over 5 years, and that includes the changes that would make the credit more valuable and more of an incentive for smaller companies, not by changing the percentage, but by allowing the credit to be carried forward to the future.

Mr. HERGER. If Congress were to allow this credit to expire, what do you feel the result would be?

Ms. RAINES. Already, companies have said that uncertainty about the orphan drug law itself and the credit has discouraged them from developing products for those markets. I am aware of several companies that probably prefer not to be named publicly who are no longer doing orphan drug research.

We have made a commitment to orphan drug research in a number of areas where it just makes sense, regardless of the credit, for us to continue. Whether we will start new programs in the absence of the credit is another question.

Mr. HERGER. Particularly with those drugs with little usage. The drugs that were for special needs would particularly be hard hit. Even though the drugs may be very effective, because there would not be much of a sale for them, they would have a difficult time.

Ms. RAINES. That is absolutely correct.

Mr. HERGER. Thank you very much.

Mr. Joseph, I have a couple of questions for you, if I could. What percentage would you estimate of gifts to private foundations are made in the form of publicly traded stock? Would you have any estimate of that?

Mr. JOSEPH. Mr. Chairman, there is no quantitative data available, but if you look at the period in which this provision was in effect, during that period we averaged about 256 new foundations a year for that decade. In the decade before we only had 79. The only quantitative data is from the State of Michigan who reported that there were 52 foundations in the last 6 years formed with appreciated stock in the State of Michigan.

Mr. HERGER. I am not sure if you have any data on this, but in general the stock is usually maintained or sold as part of the endowment, and, if sold, is that within a short time after receipt or over a period of time that the market need would indicate appropriate? Do you have any knowledge on this?

Mr. JOSEPH. No, we do not have any data on that. I can look at what is available and provide what I can, but it is mostly anecdotal and reports from individual lawyers, accountants, attorneys, and real estate planners who call our offices.

Mr. HERGER. Thank you very much.

I thank each of the Members of our panel for your testimony. With that, we will conclude this Subcommittee of Oversight of Ways and Means. Again, thank you very much.

The Subcommittee stands adjourned.

[Whereupon, at 4:35 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

BEFORE THE

COMMITTEE ON WAYS AND MEANS

OVERSIGHT SUBCOMMITTEE

UNITED STATES HOUSE OF REPRESENTATIVES
WASHINGTON, D.C.

HEARING DATE - MAY 9, 1995

Statement of Stephen A. Alterman
President
Air Freight Association
1220 19th Street, N.W.
Suite 400
Washington, D.C. 20036

H.R. 752 - A Bill to Repeal the Tax on Commercial Aviation Fuel

The Air Freight Association is a nationwide trade organization representing the interests of United States all-cargo airlines. Our membership includes virtually all of the country's major all-cargo carriers, as well as other companies and individuals with a stake in the air freight marketplace. A current Membership List is attached hereto. On behalf of our membership, we urge that H.R. 752, a Bill to repeal the tax on commercial aviation fuel, be enacted by the Congress of the United States. In support of this position, the Association states as follows:

At the present time, the airline industry is exempt from the 4.3 cent per gallon tax on aviation fuel. This exemption was based on a recognition that the United States airline industry generally has been experiencing difficult financial times and that a 4.3 cent fuel tax increase would only exacerbate these problems. However, by its terms, the exemption expires on September 30, 1995 (26 U.S.C. 4092(b)) and the industry is again faced with a significant potential financial liability. Current estimates indicate that, as an industry, the airlines will pay more than **$527 million** annually in these new taxes alone. These fees are in addition to the **$6.5 billion** the industry and its customers already pay annually in passenger and cargo taxes.

While airline fortunes have improved somewhat in the past two years, it will literally take years to recover from the recent history of losses. Over the past four years alone, the industry has lost upwards of $13 billion. In addition, during this time period, over 100,000 airline jobs have been lost. Indeed, even in the best of times (and even for the most profitable companies), the profit margin for industry members is slim.[1] Now is not the time to reverse any gains made by imposing a new tax on the airline community.

Moreover, it should be recognized that, contrary to the assertion of some observers, the airline industry, and its users, fully pays for the services used. Both the 10% passenger ticket tax and the 6.25% cargo waybill tax raise enough money the support the private portion of the nation's aviation system. And the "public contribution" of slightly over $2 billion annually is not a subsidy, but rather payment for the use of the system by the military and public aircraft.

In short, the airline community should not be expected to pay a disproportionate share of the nation's tax burden. We do not oppose the user fee concept, but it is unfair to expect us to subsidize the rest of society. The imposition of the added 4.3 cent per gallon tax would be just such an unfair burden.

Accordingly, the Air Freight Association urges that H.R. 752 be enacted and the 4.3 cent per gallon levy be repealed. Thank you very much for the opportunity to comment on this important issue.

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[1] The Air Transport Association has stated that the industry's highest annual profit was only 2.6% of revenue (in 1988).

AIR FREIGHT ASSOCIATION MEMBERSHIP LIST

COMPANY	CITY, STATE
Air Cargo Management Group	Seattle, WA
Air Courier Conference of America (ACCA)	Washington, DC
Airborne Express	Seattle, WA
Alaska International Airport System	Anchorage, AK
American Cargo Handling Equipment	Denver, CO
American International Airways	Ypsilanti, MI
Arrow Airways, Inc.	Miami, FL
Burlington Air Express	Irvine, CA
Colography Group	Marietta, GA
Columbia Metropolitan Airport	Columbia, SC
Emery Worldwide, A CF Company	Palo Alto, CA
Express One International	Dallas, TX
Federal Express Corporation	Memphis, TN
FIDC/Fairbanks International Airport	Fairbanks, AK
Harrow & Company	New Canaan, CT
Keiser & Associates	Oakland, CA
Kitty Hawk Group	Dallas/Fort Worth, TX
The Campbell Aviation Group, Inc.	Alexandria, VA
Metropolitan Washington Airports Authority	Washington, DC
Northern Air Cargo	Anchorage, AK
Roadway Package Systems, Inc.	Pittsburgh, PA
Ryan International Airlines, Inc.	Wichita, KS
Southern Air Transport	Miami, FL
United Parcel Service	Louisville, KY
World Aviation Directory	Washington, DC

STATEMENT OF

CAPTAIN J. RANDOLPH BABBITT, PRESIDENT

AIR LINE PILOTS ASSOCIATION

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

COMMITTEE ON WAYS AND MEANS

U.S. HOUSE OF REPRESENTATIVES

MAY 9, 1995

THE IMPACT OF THE JET FUEL TAX ON THE AIRLINE INDUSTRY

Good morning, Madam Chairman, and members of the subcommittee, I am Captain Randolph Babbitt, president of the Air Line Pilots Association, which represents 42,000 pilots who fly for 37 airlines. I am also a former member of the National Commission to Ensure A Strong Competitive Airline Industry, which was created in 1993 by Public Law 103-13. I appreciate this opportunity to discuss with you a provision of the tax code which will have a devastating effect on our industry, namely the 4.3 cents per gallon tax on commercial aviation fuel which is scheduled to take effect on October 1 of this year.

Since 1990 alone, U.S. airlines have lost a combined total of more than $12.8 billion. While the financial suffering has been substantial, what is clearly most distressing is the toll these losses have had on the industry's employees. During this time, 120,000 U.S. airline employees and 125,000 U.S. aircraft manufacturing employees have lost their jobs. Time and time again, airlines have asked employees for relief and they have responded with pay and benefit concessions totaling in the billions of dollars. It is significant to note that at one company, employees recently gave wage and benefit concessions in excess of $4.9 billion over six years in exchange for majority ownership of the company. At other carriers, employee give-backs have averaged between 10 and 14%.

After this disastrous economic period, our airline industry is finally beginning to make a slight recovery. According to industry sources, U.S. air carriers ended 1994 with a cumulative loss for the year of $100 million, compared to the previous year's loss of $2.1 billion. Further, we were able to avoid any bankruptcies, and no significant asset sales or mergers occurred. Passenger traffic is beginning to increase, and capacity is becoming rationalized as carriers learn to live in low yield markets.

This very modest turnaround may, however, be quickly wiped out if the government is allowed to impose the 4.3 cents per gallon tax on jet fuel beginning on October 1 of this year. It is estimated that this new tax will cost the industry more than $527 million annually, and due to the elasticity of air travel demand, airlines will simply not be able to pass the tax on to the consumer. Industry analysts have in fact concluded that each 1% increase in the price of an airline ticket results in a 1% decrease in passenger traffic. We believe that imposition of this tax will not only invalidate the employee concessions I alluded to earlier but will also lead to an untold number of lost jobs, and perhaps, lost airlines.

Commercial jet fuel has never been taxed, and it never should be. The airline industry already reels under a host of taxes and user fees that are estimated at $6.5 billion annually. These include the 10% excise tax on airline tickets and a 6.25% excise tax on cargo shipments, a $6.00 International Departure Tax, a $6.50 Customs User Fee, a $6.00 Immigration User Fee, a $1.45 Agricultural Inspection Fee, and at many airports, a $3.00 Passenger Facility Charge. These are in addition to the Federal and state income, local property, and other taxes which businesses must pay. Taken together, the taxes and fees paid by the airlines are equal to a 52.5 cents per gallon

tax. In addition, in 1990, the Congress mandated that the airlines phase out the nosier "Stage 2" aircraft with quieter "Stage 3" jets by the year 2000. This will entail either replacement, re-engining, or installing hush kits on a great deal of the existing fleet. At a time when the industry is only beginning to eke out a profit after years of heavy losses, every additional operating expense distracts U.S. airlines from the costly legislative requirement to update their fleets

Nearly two years ago, the Administration and the Congress established the National Commission to Ensure a Strong Competitive Airline Industry, on which I was proud to serve. After careful and exhaustive examination of the industry's precarious financial condition, we concluded that the airlines are already over taxed and imposition of any new taxes, particularly the fuel tax, would be ill-advised. The Commission could see no good public policy reason for changing the tax treatment of airline fuel, one of the industry's two highest cost items. I strongly supported that decision then and I do now. All this tax can do is hurt--hurt airline travelers, hurt airline employees, hurt airlines, hurt airports, and therefore in the long run, hurt this country.

The Air Line Pilots Association is particularly grateful that many members of Congress have recognized that imposition of the fuel tax would be unconscionable and that legislation has been introduced in both the House and Senate to repeal it. We strongly support H.R. 752 as introduced by Rep. Mac Collins(R-GA) and S. 304 as introduced by Senator Rick Santorum (R-PA)., and urge favorable action as soon as possible. By repealing the fuel tax the Congress will demonstrate its commitment to this beleaguered industry and its employees and give them the opportunity to remain competitive in the global marketplace. Thank you for your consideration.

SUBMITTED STATEMENT OF THE AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS TO THE SUBCOMMITTEE ON OVERSIGHT OF THE HOUSE WAYS AND MEANS COMMITTEE ON THE SECTION 127 EXCLUSION FROM TAXABLE INCOME OF EMPLOYER-PROVIDED EDUCATIONAL ASSISTANCE

MAY 9, 1995

The AFL-CIO appreciates this opportunity to provide its views on Internal Revenue Code Section 127. H.R. 127, a bill introduced by Representatives Sander Levin (D-MI) and Clay Shaw (R-FL), would make permanent the Section 127 exclusion from taxable income of employer-provided educational assistance. This bill has and deserves the AFL-CIO's strong support.

Increased investment in worker education and training is a national economic imperative. Despite that, the Congress appears close to scaling back, perhaps drastically, the federal government's already inadequate expenditures in these areas. The December 31, 1994 expiration of Section 127 will make this bad situation even worse.

Since it became law in 1978, Section 127 permitted more than seven million workers to exclude employer-provided educational assistance from their incomes for federal income tax purposes. Section 127 thereby encouraged these workers, more than 99% of whom earned less than $50,000 per year, to take courses and pursue other opportunities for education and training, and to update and improve their skills.

In unionized sectors, Section 127 also contributed to the establishment and expansion of collectively bargained educational assistance programs, one of the most important and far-reaching collective bargaining innovations of the 1980s. During that decade, an impressive array of collectively bargained programs that allow workers to upgrade their skills and further their education was put in place by unions and employers in the auto industry, the telecommunications industry, the steel industry and many others, in the service, manufacturing, public and private sectors.

Examples include the UAW-Ford Education, Development and Training Program (EDTP) which was established in 1982; similar programs involving the UAW and General Motors and the UAW and Chrysler; The Alliance for Employee Growth and Development, which was established in 1986 between the Communications Workers of America (CWA), the International Brotherhood of Electrical Workers (IBEW) and AT&T; the Enhanced Training Opportunities Program (ETOP) covering IBEW represented AT&T manufacturing workers; programs involving the CWA and AmeriTech, NYNEX, U.S. West, Bell Atlantic, Bell South and Cincinnati Bell; programs involving the IBEW and GTE, NYNEX, AmeriTech, U.S. West, United Telecom, Alltel, Allnet and the Centel Division of Sprint; the Service Employees International Union's Lifelong Education and Development Program, and its outgrowths such as the Career Ladder

Program at Cape Cod Hospital in Massachusetts; The Education Fund covering workers represented by the American Federation of State, County and Municipal Employees (AFSCME) District Council 37 employed by New York City; the Upward Mobility Program established between AFSCME District Council 31 and the State of Illinois; the Joint International Association of Machinists (IAM)/Boeing Quality Through Training Program; and the Institute for Career Development, a joint effort of the United Steelworkers of America and the major steel companies. This is just a partial list.

These programs often serve both active and displaced workers, and provide a wide range of services, such as individualized educational planning and assessment, pre-paid tuition for approved courses, and personal enhancement opportunities to brush up on reading, writing and mathematics skills. Hundreds of thousands of workers have gained access to employer-provided educational assistance as a result.

Despite these highly successful collectively bargained programs, most U.S. employers still invest far too little in the education and training of their workforce, particularly those workers who are not college graduates. When the federal government should be encouraging such investments, allowing the Section 127 exclusion to expire sends precisely the wrong message.

Without the Section 127 exclusion, many workers will not be able to afford to pursue education and training opportunities, even with employer assistance. Including contributions for Social Security and Medicare, taxes could cost workers 25% or more of their educational assistance benefit even though their cash earnings have not increased. Since 99% of the workers receiving educational assistance under Section 127 have earnings of $50,000 per year or less, and 71% have earnings of $30,000 or less, many workers who are eligible for educational assistance will no longer be able to afford to take advantage of it.

Laid-off workers, who badly need educational assistance to retrain and qualify for new jobs, will be among those who are hurt the worst. After Section 127 was scheduled to expire at the end of 1987, the UAW noted that applications from laid-off workers for educational assistance dropped at all of the major auto companies in 1988.

The Section 127 exclusion is estimated to cost a modest $300 million per year in lost tax revenues. This is a small price to pay for encouraging and enabling workers to take advantage of employer-provided educational assistance. There can be little doubt that the Treasury recoups the public's investment many times over in higher tax revenues on the increased stream of future earnings that additional worker education and training make possible.

The AFL-CIO urges the Congress to make the Section 127 exclusion permanent. Eight times since 1986, the Section 127 exclusion has been scheduled to expire. Seven times, it has been extended by the Congress, on six of those occasions retroactively. Every time Section 127 has been scheduled to expire, the resulting uncertainty has been detrimental to the utilization of employer-provided educational assistance. The time has come to recognize the important public purpose served by the Section 127 exclusion, end the counterproductive uncertainty, and make the exclusion permanent.

STATEMENT OF
THE AMERICAN FEDERATION OF TEACHERS
ON SECTION 127, THE EXCLUSION FOR EMPLOYER-PROVIDED EDUCATIONAL ASSISTANCE

SUBMITTED TO
THE SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
FOR THE HEARING RECORD OF
MAY 9, 1995

The American Federation of Teachers appreciates the opportunity to share its views on the tax exclusion for employer-provided educational assistance. The AFT strongly supports swift action on H.R. 127, which would restore and make permanent the Section 127 exclusion for employer-paid educational benefits.

A well educated, highly skilled workforce is essential if our country is to meet the challenges of today's global economy. Since 1978, Section 127 has helped more than 7 million working Americans to attend classes in order to improve their skills and expand their economic opportunities.

The AFT's 875,000 members include teachers, classified school employees, paraprofessionals, and health care workers who have benefited from the educational opportunities made possible through Section 127. AFT locals throughout the country collectively bargain for educational benefits in their contracts, and better teachers, paraprofessionals and nurses result from the additional education they receive.

Section 127 can also play a significant role in helping our nation's school system meet its teaching needs. Current projections suggest an increasing demand for teachers through this decade and into the next century due to retirement, attrition, and a growing student population. In addition, we are already facing teacher shortages in a number of key specialty areas such as math, science, English as a second language, vocational education, computer science, foreign languages, and special education.

Many programs of teacher education and retraining which have been designed to increase the supply of teachers in shortage areas could be jeopardized in the absence of Section 127. Our teachers have participated in programs that pay for credits in special education, bilingual education, and vocational education, as well as other fields where shortages exist. The Intensive Teacher Institute offered by the State of New York, for example, currently pays for 18 credits to encourage teachers to become certified in bilingual special education.

In addition to their role in increasing the supply of teachers in critically short specialties, employer-provided educational benefits have also proved to be an important tool in attracting teaching candidates from other sources. A number of AFT locals

throughout the country have negotiated career ladders for their paraprofessionals and school aides, which help them to earn their college degrees through employer-paid educational assistance, release time, and summer stipends. More than 7,000 paraprofessionals in New York City have utilized the career ladder negotiated by their local, the United Federation of Teachers (UFT), to obtain their college degrees. Many of them have moved up in the education system, becoming teachers, guidance counselors, school secretaries, and assistant principals. Others have graduated from college and gone on to success in other fields. Over 6,000 UFT members are currently using the career ladder, and many more will enter it in the fall. In Baltimore, some 800 paraprofessionals a year are earning college credits through the career ladder negotiated by their local, and similar programs are under way in Massachusetts, Ohio, Florida, Oregon, Pennsylvania, and other sites throughout the country.

The success of these programs is particularly satisfying, since many of the participants are single parents who came to the classroom from the welfare rolls, often with no employment history and without even a high school diploma. Many of these individuals simply could not afford to take advantage of the opportunities offered through career ladders if they had to pay taxes on their educational benefits.

Restoration of Section 127 is also extremely important to health care workers represented by AFT whose contracts provide for tuition reimbursement by their employers. These educational benefits allow nurses and other health care workers to obtain Bachelor of Science degrees and to upgrade their skills and train for better jobs in a variety of critical medical specialties.

Section 127 has been highly successful in helping AFT members and other workers who wish to improve their skills and expand their economic opportunities by preparing themselves for better jobs. The AFT strongly believes that Section 127 should be restored and made a permanent part of the tax code. Since its enactment in 1978, the provision has been extended seven times, sometimes retroactively after a lapse of several months. This kind of uncertainty makes planning difficult and creates paperwork burdens for employers and employees alike. It can also discourage the participation of low-income workers who fear that they may have to pay taxes on their educational benefits.

Education is the key to increasing our economic productivity and ensuring that we can compete internationally in the 21st century. The permanent restoration of Section 127 will be a wise investment in America's workers and our nation's future.

Governmental Affairs
American
Hotel & Motel
Association

May 17, 1995

The Honorable Nancy L. Johnson
Chairwoman, Subcommittee on Oversight
Committee on Ways and Means
U.S. House of Representatives
Washington, DC 20515

Dear Chairwoman Johnson:

The American Hotel & Motel Association, the trade association of the lodging industry, representing in excess of 10,000 properties through a federation of state and local lodging associations, offers the following comments for the record of the Subcommittee's May 9, 1995 hearing on the Targeted Jobs Tax Credit (TJTC). As a member of the Committee for Employment Opportunities we wish to endorse the testimony of that group as presented to you by Janet M. Tully of Marriott International.

TJTC has proven to be an effective program for companies in our industry, having a positive effect on the hiring of individuals in the designated categories. The existence of a partial tax credit has helped offset higher training costs, initial lower productivity, and the extra expenditure of management time necessary to bring these employees up to levels of productivity equivalent to others in the work force. By allowing companies a method of offsetting those costs, TJTC has created a positive incentive to seek out and hire qualifying individuals.

Much has been made recently of reports and statements suggesting that many if not most individuals hired under TJTC would have been hired anyway to fill positions and that therefore TJTC is ineffective. While we do not believe this has been the case, we agree that the fundamentally changed model presented to this subcommittee will resolve that issue once and for all. TJTC exists because it was recognized that some individuals need help in breaking into the job market. TJTC provides that help by creating an incentive for employers which balances out the extra costs associated with training these individuals in the job skills needed in the work place. In addition, the new approach identifies individuals for willing employers to bring into the work force.

Despite the fact that this program has been disrupted several times by limited extensions which have been allowed to lapse and by short term renewals, it continues to be strongly supported both by business groups and individuals who are benefited by the opportunities created. TJTC should remain available on a reliable basis into the future to continue the salutary effect it has had on bringing into the work force individuals in the targeted disadvantaged categories.

We urge the Subcommittee to pass the revised version of TJTC presented to it and to do so on a permanent basis to ensure that this workable program remains available and is no longer threatened by periodic interruption.

Sincerely,

James E. Gaffigan
Vice President, Governmental Affairs

STATEMENT OF THE AMERICAN SOCIETY FOR TRAINING AND DEVELOPMENT

The American Society for Training and Development (ASTD) appreciates the opportunity to submit testimony for the record, regarding the reauthorization of Section 127 of the Internal Revenue Code, Employer-Provided Educational Assistance.

The American Society for Training and Development (ASTD), represents more than 58,000 workplace-based specialists in training, learning and performance. Members work in multinational companies, small businesses, virtual corporations, industry associations, government agencies, and colleges and universities.

ASTD's mission is to provide leadership to individuals, organizations and society in order to achieve work-related competence, performance and fulfillment.

As the pace of economic and technological change accelerates, the ability of workers and enterprises to learn and adapt becomes a core element in global competition. Success in the global economy therefore, requires companies to become high performance workplaces that integrate a skilled and educated workforce with technology, efficient systems of work organization, and continuous innovation. As a result, learning and the ability to create, extend and apply knowledge have become a critical component in the practices which result in high performance.

To build and maintain a skilled workforce, incentives are needed that encourage future training and education. For this reason, ASTD strongly supports the reauthorization of Section 127, which has been used by more than 7 million Americans workers, to pursue college or graduate-level education.

SECTION 127 BENEFITS

Section 127, which expired on December 31, 1994 allowed employers to provide up to $5250 a year in nontaxable reimbursements or direct payments to employees for non-job-related tuition, fees, and books for both undergraduate and graduate courses.

Workers have used Section 127 to improve skills and obtain better jobs. Without this tax exclusions, many workers will not be able afford courses needed to enhance their capabilities.

A 1989 study showed that nearly 99 percent of workers using the Section 127 benefit earned less than $50,000 a year, 71% earned less than $30,000 a year, and 35 percent earned less than $20,000. Taxes could cost those workers 25 percent or more of the benefit, which employers would have to withhold from their take-home pay.

Additionally, employers have used Section 127 as a valuable tool for retraining workers for other work within the company or, in the case of layoffs, for other employment in the community. The benefits have been an important way to maintain a competitive, well-trained workforce in today's global marketplace.

IMPACTS OF THE EXPIRATION OF SECTION 127

The history of Section 127 clearly points to the need for Congress to make this tax provision permanent. Prior to the enactment of Section 127, which occurred in 1978, only specifically "job related" education was excluded from gross taxable income. As a result, Congress enacted Section 127, which was designed to reduce administrative inequities arising from uncertainties often reflected in conflicting court decisions over what was and was not job-related education; reduce tax code complexity; and remove disincentives to upward mobility.

Since 1978, Congress has extended Section 127 seven times and, on six of those occasions, applied it retroactively. Although Congressional extensions have been positive, the uncertainty regarding the status of Section 127, has frequently discouraged workers and employers form using the tax exclusion. As a result, more than 1,000 workers at a major manufacturer already using Section 127, dropped out of classes when their educational assistance became taxable.

Further, the expiration of Section 127 has left only job-related training assistance exempt from an employees' gross taxable income under a separate and permanent section of the revenue code - 1.162.5.

MAKING SECTION 127 PERMANENT

Legislation (H.R. 127) that would reauthorize and make Section 127 permanent, has been introduced by Representatives Sander Levin (D-MI) and Clay Shaw (R-FL). Although ASTD recognizes that many programs may not be funded based on the current fiscal situation, ASTD strongly encourages Congress to support this bill, which would ensure that low and middle-income workers may continue to pursue lifelong learning through training and education.

CONCLUSION

Continuous education and training of the U.S. workforce is critical to meeting the challenges of the global economy. Through Section 127, employers have an opportunity to retrain workers and ensure that individuals obtain the skills needed to move into high wage jobs.

ASTD appreciates the opportunity to comment on the reauthorization of Section 127, and is supportive of the committee's efforts to examine this very important issue.

STATEMENT OF
THE AMERICAN SOCIETY OF MECHANICAL ENGINEERS
ON THE INTERNAL REVENUE CODE SECTION 127
EMPLOYER-PROVIDED EDUCATIONAL ASSISTANCE PROVISIONS

SUBMITTED TO THE WAYS AND MEANS COMMITTEE
U.S. HOUSE OF REPRESENTATIVES
MAY 9, 1995

The American Society of Mechanical Engineers (ASME) strongly supports legislation to make permanent the Internal Revenue Code Section 127 exclusion for employer-paid educational assistance. Section 127 expired on December 31, 1994.

The 125,000-member ASME is a worldwide engineering society focused on technical, educational, and research issues. It conducts one of the world's largest technical publishing operations, holds some 30 technical conferences and 200 professional development courses each year, and sets many industrial and manufacturing standards.

We strongly support congressional efforts, in particular H.R. 127, to make permanent the Section 127 Internal Revenue Code employee educational assistance provisions. These provisions allow employers to provide their employees tax-free reimbursements for tuition, books, and fees for non job-related educational assistance.

Pressures of international economic competition are shaping a new environment for employer-employee relationships, requiring greater job flexibility, job mobility, and frequent updating of skills. The American demographic trend toward an older work force, the continuing shift toward a service economy, and rapid advances in knowledge and technology clearly point to the need for public policies which support and encourage lifelong education.

Continuing education and retraining programs are especially critical for engineers to keep up-to-date with rapidly changing technology in their field or to switch areas of engineering specialization. Moreover, a well-trained engineering work force is vital to our nation's economic well-being.

Section 127 of the Internal Revenue Code has exempted qualified employee educational assistance from employee federal income taxes. The Section's expiration has caused confusion and concern among participants in this program. In the absence of Section 127, the law requires employees to pay taxes on tuition payments made by their employers unless the courses are strictly "job-related." The expiration of the Section 127 provisions is keeping many engineers from pursuing the advanced degrees they need to compete, and to help our nation compete, in the ever-changing world of engineering technology.

Section 127 has had an important role to play in the retraining of engineers employed by the defense dependent industries impacted by defense downsizing. Employee educational assistance would provide these engineers with the opportunity to continue their education in new fields of engineering technology which can be used in both military and civilian applications. This in turn would assist the defense industry in expediting the conversion of their products from defense to domestic markets.

Section 127 works. Since 1978, employee educational assistance has enabled more than seven million American workers to upgrade their skills and keep pace with new competitive, technological, and industrial developments. Over 95 percent of the participants in ASME's continuing education courses in the Society's professional development program have been supported by their employers through tuition reimbursement.

We believe that Section 127 is analogous to the GI Bill of Rights: an investment in the future. In our experience, continuing education is an investment, not a fringe benefit. It should be considered a business expense, required for a company to remain competitive. With the appropriate mix of educational programs, we can improve our quality of life while improving the nation's industrial competitiveness and balance of trade; we can improve productivity while improving the quality of our products.

Finally, we believe that permanent implementation of Section 127 would not be a revenue loser for the federal treasury. We believe the revenue foregone from not taxing employee educational assistance will be recovered many times over in additional tax revenues from economic activities generated by a continuously employed, well-educated work force. It should also be noted that the "cost" of Section 127 is very low compared to the alternative of expanding direct funding for educational programs and retraining.

In conclusion, we urge Congress to move expeditiously to make Section 127 a permanent part of the Internal Revenue Code. It is a critical component of the national effort to enhance the education, job skills, and retraining of American workers. Clearly, Section 127 is a cost-effective investment in the future of America.

STATEMENT OF THE ASSOCIATION OF AMERICAN RAILROADS
on the
ELIMINATION
of the
1.25 CENT-PER-GALLON DEFICIT REDUCTION FUELS TAX
submitted to the
SUBCOMMITTEE ON OVERSIGHT
OF THE
HOUSE COMMITTEE ON WAYS AND MEANS

May 9, 1995

The Subcommittee on Oversight's hearing on the October 1, 1995, expiration of the aviation jet fuel exemption from the Transportation Fuels tax presents an opportunity to examine a clear tax inequity assessed against America's railroads. Effective October 1, 1995, the railroads will be unfairly left as the only transportation mode paying the 1.25 cents-per-gallon deficit reduction fuel tax. It is simply discriminatory to require railroads to pay 1.25 cents more per gallon towards deficit reduction than their major competitors. The Association of American Railroads strongly urges, as a matter of fundamental fairness, that all modes of transportation should pay the same fuel tax toward deficit reduction.

I. UNDER CURRENT LAW BOTH RAILROADS AND THEIR MAJOR COMPETITORS CONTRIBUTE EQUALLY TO DEFICIT REDUCTION.

Prior to the 1990 Reconciliation Act, the sole purpose of the transportation fuels tax was to finance the Highway Trust Fund. Therefore, railroads (like other off-highway users) did not pay this tax. The 1990 Act arbitrarily extended the fuel tax beyond its historical role as a highway user fee, by introducing a 2.5 cents-per-gallon deficit reduction tax on transportation fuels.

The original 2.5 cent tax was payable by most transportation modes (except barges) into the general fund of the Treasury. The 1993 Reconciliation Act imposed an additional 4.3 cents-per gallon deficit reduction rate on all transportation modes, in addition to modifying the 2.5-cents rate. At present and until October 1, 1995, both railroads and trucks pay a combined deficit reduction rate of 6.8 (4.3 plus 2.5) cents-per-gallon of transportation fuel.

II. UNDER 1993 AMENDMENTS SCHEDULED TO TAKE EFFECT ON OCTOBER 1, 1995, RAILROADS WILL BE AT AN UNFAIR COMPETITIVE DISADVANTAGE, BECAUSE THEY WILL BE REQUIRED TO PAY MORE TOWARDS DEFICIT REDUCTION THAN THEIR COMPETITORS.

Under the 1993 Reconciliation Act, the 2.5-cents tax paid by highway users will be redirected into the Highway Trust Fund. Thus, on October 1, 1995, railroads will be left as the only payers of the original deficit reduction tax at a rate of 1.25 cents-per-gallon. As a result, on October 1, 1995, highway users will pay only 4.3 cents-per-gallon into Treasury's general fund, while railroads will pay 5.55 (4.3 plus 1.25) cents-per-gallon for deficit reduction. Thus, the railroad industry will be at an unfair competitive disadvantage, unless the deficit reduction rate levied on the railroads is reduced to the level of its competitors.

III. THE DEFICIT REDUCTION FUEL TAX IMPOSED ON RAILROADS SHOULD BE REPEALED, TO THE EXTENT THAT ANY PORTION OF THE TAX PAID BY HIGHWAY USERS IS DIVERTED TO THE HIGHWAY TRUST FUND.

Tax equity requires the recognition of basic differences regarding the financing of infrastructure used by competing modes of surface transportation: (1) the Highway Trust Fund, funded by highway user taxes, provides the financing for the construction and maintenance of the public roads used by trucks, while (2) the railroad industry operates over its own privately funded rights-of-way, with respect to which the industry pays significant property taxes. Thus, the railroads's fuel tax payments should never be diverted to the Highway Trust Fund; such a result would unfairly force the railroads to pay for the infrastructure used by their competitors (in addition to their own). Moreover, because the railroads do not enjoy, require, or want a trust fund, the diversion of the excise tax paid by trucks into the Highway Trust Fund should be balanced by the repeal of the fuel tax paid by railroads.

IV. ALTERNATIVELY, TO AVOID ANY REVENUE SHORTFALL, THE SAME AMOUNT OF TAXES RAISED BY THE 1.25-CENT RATE ON RAILROADS CAN BE GENERATED BY REQUIRING DEFICIT REDUCTION PAYMENTS AT A LOWER RATE BY ALL MODES OF TRANSPORTATION.

The alternative proposal would allow fuel taxes paid by the other modes to be directed into their respective trust funds in a revenue neutral manner, with all modes contributing equally to deficit reduction. For example, a .028 cent-per-gallon tax on fuel used by the same transporters, including railroads, subject to the 1993 deficit reduction tax would raise enough revenue to eliminate the 1.25-cent discriminatory tax on railroads. As long as the fuel tax is viewed as an appropriate vehicle for deficit reduction, all transporters should be required to make equal contributions.

CONCLUSION

Competing modes of surface transportation should be required to make equal contributions to deficit reduction. The Association of American Railroads urges the elimination of the 1.25 cent-per-gallon deficit reduction tax on railroads (scheduled to take effect on October 1, 1995) as a matter of fundamental fairness.

STATEMENT OF J. VERNON HINELY
CHAIRMAN AND CHIEF EXECUTIVE OFFICER
CARBONIC INDUSTRIES CORPORATION
on the
ELIMINATION OF THE UNINTENDED TAX SUBSIDY FOR CARBON DIOXIDE PRODUCED AS A BY-PRODUCT OF ETHANOL
submitted to the
SUBCOMMITTEE ON OVERSIGHT
of the
HOUSE COMMITTEE ON WAYS AND MEANS

May 9, 1995

I. INTRODUCTION

The Subcommittee on Oversight's hearing on the expiration of the aviation jet fuel exemption from the Transportation Fuels tax presents the opportunity to review a related issue involving the way in which the fuel tax exemptions for ethanol have disrupted the traditional carbon dioxide ("CO2") market by virtue of the unintended subsidy made available to ethanol-based CO2. I and others in my industry strongly urge, as a matter of fundamental fairness, the enactment of legislation to "back out" the cost advantage that ethanol producers obtain when they co-generate CO2 for sale in the retail market.

The Cato Institute recently identified the ethanol tax subsidies as a prime target for "corporate welfare reform." At the very least, these tax subsidies should be reduced, because a federal subsidy is unnecessary to the extent current law already enables ethanol producers to supplement their revenues by selling CO2 at retail.

II. THE CARBON DIOXIDE INDUSTRY MATURED WITHOUT THE AID OF FEDERAL SUBSIDIES

A mature (half billion dollar a year) CO2 market developed in this country without the benefit of federal government subsidies. Refined CO2 has countless commercial applications, including food preservation, beverage carbonation, water treatment, and firefighting. Because there are few natural CO2 gas wells, the primary source of CO2 is as an industrial by-product, particularly from ammonia production and petroleum refining.

CO2 is a gas that is found naturally in our atmosphere. The commercial production of CO2 begins with CO2 in a gaseous state; liquid CO2 is produced by cooling and compressing carbon dioxide gas under high pressures. Below -69.9 degrees Fahrenheit, liquid CO2 freezes to form a solid (known commonly as "dry ice").

It is uneconomic to transport crude CO2 gas, even over a distance as short as a quarter of a mile. For this reason, CO2 refining operations[1] are located at the source -- that is, a CO2 company's recovery and processing equipment must be connected to an unrelated supplier's industrial plant. The economics of transporting raw CO2 also explains why there is no national wholesale market for this commodity; instead, there are overlapping regional wholesale markets.

The aggregate wholesale market is a "seller's market," characterized by sharp competition for reliable streams of CO2 of sufficient purity and volume. Not surprisingly, longterm "take or pay" supply contracts are prevalent. The typical CO2 supply contract has a term of 15 years and calls for a fixed price.

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[1] A merchant liquid carbon dioxide plant consists of filtration, compression, and refrigeration equipment with related controls, instrumentation, and storage.

III. THE ETHANOL MARKET AS WE KNOW IT TODAY WOULD NOT EXIST BUT FOR FEDERAL TAX SUBSIDIES.[2]

Ethanol is an alcohol that may be produced from a variety of feedstocks, although about 95 percent of current ethanol production is derived from corn. Beginning in 1978, the Congress enacted five tax incentives to encourage the use of ethanol in gasoline and diesel: (a) exemptions from the motor fuels excise taxes on gasoline and diesel (generally referred to as the "Gas tax"); (b) a blender's tax credit; (c) a small ethanol producers tax credit; (d) tax deductions for clean-fuel burning vehicles; and (5) the alternative fuels production tax credit. Since the enactment of the first Gas tax exemption, the ethanol fuels market has expanded from a few million gallons per year prior to 1978 to over a billion gallons per year today.[3]

A. The Gas Tax Exemption Has Been The Most Effective Federal Tax Incentive In Stimulating Ethanol Production.

The Gas tax is imposed at the rate of 18.4 cents per gallon on gasoline and 24.4 cents per gallon on diesel used in highway motor vehicles. 11.5 cents of the 18.4 cents rate (17.5 cents of the diesel tax rate) finances the Highway Trust Fund.[4] While the Gas tax has always had an expiration date (and is currently scheduled to expire on October 1, 1999) it has always been extended before expiration.

1. The Internal Revenue Code Provides For Three Tiers Of Exemptions, Depending On The Percentage Of Ethanol Per Gallon Of Gasoline.

Gasohol -- blends of gasoline and ethanol that are at least 10 percent ethanol -- is exempt from 5.4 cents of the 18.4 cents Gas tax; thus, gasohol is taxed at only 13 cents per gallon. Mixtures of gasoline and ethanol that are at least 7.7 percent ethanol are exempt from 4.16 cents of the Gas tax, and mixtures that are 5.7 percent ethanol are exempt from 3.08 cents of the Gas tax. Straight alcohol fuels also qualify for Gas tax exemptions. Ethanol that qualifies for the Gas tax exemption must meet two definitional requirements. First, the ethanol cannot be derived from petroleum, natural gas, or coal (including peat). Secondly, the ethanol must be at least 190 proof (or, 95 percent pure alcohol, determined without regard to any denaturants). The Gas tax exemptions for ethanol expire after September 30, 2000.[5]

2. The Economic Benefit Of The Gas Tax Exemption Goes To Ethanol Producers.

The Gas tax is levied -- and the exemption is claimed -- at the time gasoline is removed from a "terminal" (a gasoline storage and distribution facility that is supplied by pipeline or vessel). Although the owner of the gasoline (e.g., a major oil company) is liable for the Gas tax, it is the ethanol producer that receives the economic benefit of the

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[2] The market information in this section was drawn from a recent analysis of the Federal tax incentives for ethanol: Alcohol Fuels Tax Incentives and EPAs Renewable Oxygenate Requirement, by Salvatore Lazzari, Specialist in Public Finance, Economics Division, Congressional Research Service, The Library of Congress (94-785 E) October 7, 1994.

[3] Further Administrative actions by the Environmental Protection Agency ("EPA") and Internal Revenue Service ("IRS") artificially increase the demand for ethanol. First, the EPA interpreted the Clean Air Act as giving it discretion to require that a portion of required oxygenates be derived from renewable resources, and mandated 30 percent; the U.S. Court of Appeals for the District of Columbia, however, struck down this rule on April 28, 1995. The EPA requirement effectively mandated the use of ethanol, as the technology for producing the alternative -- methanol from biomass -- is experimental and uneconomic at present; if the court case is not appealed, the case would not prevent refiners from using etanol voluntarily. Secondly, the IRS has ruled that ETBE (Ethyl Tertiary Butyl Ether, a compound --not an alcohol-- resulting from a chemical reaction between ethanol and isobutylene) qualifies for the blenders tax credit noted above.

[4] The other components of the 18.4 and 24.4 cents tax rates are a 6.8 cents Deficit Reduction rate and a .1 cent Leaking Underground Storage Tank ("LUST") rate.

[5] Regarding the difference between the dates of expiration of the Gas Tax and the exemptions, the exemptions have always been drafted to expire after the Gas Tax

Gas tax exemption. This is so because ethanol producers set their prices to be equal to the Federal tax subsidy plus the current price of unleaded gasoline[6]. Further, it is the invoice supplied by the ethanol producer that the Internal Revenue Service ("IRS") relies on in determining whether taxpayers that claimed Gas tax exemptions have complied with the definitional requirements as to source and proof of ethanol.

Note that the IRS's acceptance of an ethanol producer's invoice as proof of compliance with source and purity requirements is not misplaced. Because ethanol producers are makers of alcohol, they are closely monitored by the Bureau of Alcohol, Tobacco, and Firearms ("ATF"). Thus, the IRS can be fairly confident that an ethanol producer will have few (if any) opportunities to engage in noncompliance.

B. Ethanol Tax Credits Are Available In Lieu Of the Gas Tax exemption.

The "Blenders" credit is 54 cents per gallon of ethanol that is used in a mixture of alcohol and gasoline and sold as a fuel or used by the blender in its trade or business as a fuel. A separate 10 cents per gallon credit is provided for small ethanol producers (defined as one with ethanol production capacity of not more than 30 million gallons per year). A 54 cents per gallon credit is also available for straight ethanol. While the Gas tax exemption reduces revenues to the Highway Trust Fund, the ethanol credits reduce general revenues.

The alcohol fuel credits are designed to provide the same economic benefit as the 5.4 cents Gas tax exemption. Generally, a taxpayer has the choice of the credit or the exemption, but not both.[7] Taxpayers prefer the Gas tax exemption over the income tax credit, primarily because the exemption provides an immediate tax benefit while the credit is not claimed until an income tax return is filed (and is useful only to the extent of tax liability). Further, the exemption is more profitable, because the amount of credit is subject to tax and so the after-tax benefit is reduced to 35 cents per gallon (a 54 cents credit minus the 54 cents included in income and taxed at the 35-percent corporate income tax rate).

C. The Ethanol Industry Is Now Using Its Government Subsidized Cost Advantage to Compete In The Retail CO2 Market.[8]

Fermentation of grain in an ethanol plant generates CO2: 6.8 pounds of CO2 are produced per gallon of ethanol.[9] Utilizing their enormous capacity to generate CO2, ethanol producers are competing directly with traditional CO2 companies selling at retail.[10] The vast quantities of CO2 available to ethanol producers is a direct but unintended consequence of the Federal tax subsidies for ethanol. Because ethanol producers source their raw CO2 from themselves at virtually no cost,[11] they enjoy a competitive edge over traditional CO2 companies that purchase and refine CO2 without the benefit of a Federal tax subsidy.

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[6] See page 5 of the 1994 CRS analysis cited in note 2, above.

[7] A mixture that is more than 10 percent ethanol is eligible for both the exemption and the credit, but in such a case the credit is reduced by the amount of the exemption.

[8] See "Fed Subsidy a Gas for one Biz, a Fizzle for Other," Crain's (Metro Chicago's Business Authority) Sept. 12-18, 1994.

[9] As calculated by the Congressional Research Service in the memorandum, dated February 15, 1994, entitled "Carbon Dioxide from Ethanol Production" by David E. Gushee, a senior fellow in environmental policy.

[10] See "Improve Ethanol Project Economics With Carbon Dioxide Recovery Capability," from the Sept./Oct. 1993 issue of Fuel Reformulation magazine.

[11] See the Congressional Research memorandum cited in note 9, above.

IV. A FEDERAL TAX SUBSIDY IS UNNECESSARY TO THE EXTENT CURRENT LAW ALREADY ENABLES ETHANOL PRODUCERS TO SUPPLEMENT THEIR REVENUES BY SELLING CO2 AT RETAIL.

A. Groundwork For A Corrective Amendment Was Laid During The Last Congress.

The unintended effect of ethanol subsidies on the CO2 industry was the subject of a hearing during the last Congress where I testified before another subcommittee of the Ways and Means Committee.[12] Further, the staff of the Joint Committee on Taxation ("Joint Tax") did some preliminary work on estimating the revenue that could be raised by backing out the unintended tax subsidy for ethanol-based CO2. The proposal described herein does not involve the imposition of a new tax and would be designed to enhance revenues.

B. Current Law Should Be Amended To Reduce The Ethanol Tax Incentives By An Amount That Corresponds To The Advantage Gained In The Retail CO2 Market.

1. The Proposal Would Provide Reduced Exemption Rates For Ethanol That Is Co-generated With CO2, (Just As Current Law Already Provides Different Rates Depending On The Percentage of Ethanol).

Except in the case of alcohol produced by small ethanol producers, the proposal would provide different rates for ethanol that is co-generated with marketable quantities of refined CO2. The invoice rendered by an ethanol producer would indicate whether the alcohol was co-generated with CO2 for sale at retail. Just as under current law, ATF monitoring of ethanol production facilities should obviate any concern about non-compliance with the proposed definitional requirement. In this regard, note that the logistics of recovering and refining CO2 requires the location of a merchant liquid CO2 plant at the site of the ethanol production facility. (In contrast, the sale of CO2 by-product as crude gas eliminates much of the capital and operating expense associated with refining CO2 for sale at retail).

2. The Reduced Rates Would Be Designed To Enhance The Revenue Raised By The Proposal.

In the first instance, the reduced exemptions would not be prohibitive; that is, the rates should be set so ethanol remains competitive with other oxygenates (such as methanol). At the same time, the exemptions should take into account the supplemental revenues generated by retail sales of CO2, because it is in the retail market that ethanol producers realize the cost advantage made possible by the Federal tax subsidy.

As a starting point, the cost advantage enjoyed by ethanol producers can be quantified as follows:

(a) The average purchase price of crude CO2 is $15 per ton (exclusive of transportation and other indirect costs);

(b) It takes 294 gallons of ethanol to produce a ton of CO2 (6.8 pounds of CO2 is produced for every gallon of ethanol; and two thousand pounds divided by 6.8 is equal to 294); thus,

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[12] See "Testimony of J. Vernon Hinely, Chairman and Chief Executive Officer of Carbonic Industries Corporation, before the Subcommittee on Select Revenue Measures of the Committee on Ways and Means, on September 23, 1993."

(c) For every gallon of ethanol, a producer saves 5 cents ($15 -- the per ton purchase price for crude CO2 -- divided by the 294 gallons of ethanol required to produce a ton of CO2).

While the 5 cents per gallon savings is a clearly identifiable cost advantage that ethanol producers have over traditional CO2 companies, the revenue estimate should assume the rate reduction that would result in the smallest decline in production of ethanol-based CO2.

3. Conforming Amendments To The Ethanol Tax Credits Would Be Necessary.

Because the ethanol tax credits are designed to be equivalent to the Gas tax exemptions, the credits should be conformed to the applicable rates for ethanol that is co-generated with refined CO2

V. CONCLUSION

The Congress never intended to subsidize the production of carbon dioxide, yet that is exactly what has occurred as a result of the Gas tax exemption and related provisions of the Internal Revenue Code. As a matter of fairness and equity, I urge the enactment of the proposal that would mitigate the effects of the ethanol tax subsidy on the carbon dioxide industry by reducing the tax subsidies for ethanol that is produced as part of a process that includes co-generating and refining carbon dioxide for sale at retail.

STATEMENT OF THE COLLEGE AND UNIVERSITY PERSONNEL ASSOCIATION, SUPPORTING EMPLOYEE EDUCATIONAL ASSISTANCE (I.R. CODE SECTION 127)

The College and University Personnel Association (CUPA) is a nonprofit association that represents over 1,700 private and public college and university human resource departments throughout the United States and has an individual membership of more than 6,000 members. Our primary mission is to provide information and leadership to college and university human resource departments. Therefore, CUPA would like to submit the following written statement for the record in support of Section 127 Educational Assistance of the Internal Revenue Code (IRC).

As you are aware, Section 127 allows employers to provide up to $5,250 a year in nontaxable reimbursements or direct payments to employees for tuition, fees, and books for both undergraduate and graduate courses. Although not specifically classified as a fringe benefit, Section 127 is treated similarly to and is comparable with other benefits such as health care insurance, pension plans, and life insurance. If employers choose to provide educational assistance benefits to their employees, they must offer the benefits to all employees on a nondiscriminatory basis, which does not favor highly compensated employees.

Section 127 of the IRC was enacted first as part of the Revenue Act of 1978. Prior to 1978, only educational assistance provided by an employer to an employee that related to the individual's job was excluded from an employee's gross taxable income. The "job-related" test contained in Internal Revenue Regulation 1.162-5 was confusing and resulted in both the Internal Revenue Service and the courts making arbitrary decisions as to what type or types of employer-provided educational assistance successfully met the test of job relatedness. Additionally, most entry-level employees were unable to claim an exemption for an educational expense because their job descriptions and responsibilities were not broad enough to meet the test. In effect, only highly skilled individuals were able to use job-related educational assistance.

The 1978 effort to enact legislation to cover employer-provided educational assistance was led by Representatives Guy Vander Jagt (R-MI) and Frank Guarini (D-NJ) and received wide bipartisan support. The sponsors of the legislation believed that enactment of the provision would help to meet three goals: (1) clarify the tax treatment of employer-provided non-job-related educational assistance and job-related educational assistance; (2) reduce the inequity among taxpayers; and (3) provide less-educated and skilled employees with opportunities for upward mobility and advancement through employer-provided educational assistance. Since the 1978 enactment, supporters of Section 127 inside and outside of Congress believe the provision continues to meet the goals expressed by the original supporters of the legislation.

Due to revenue constraints, Congress has reinstated Section 127 predominantly through one to two year extensions. The last reinstatement was enacted in the Omnibus Budget Reconciliation Act of 1993 (OBRA '93) and expired on December 31, 1994. In the 104th Congress, Representatives Clay Shaw (R-FL) and Sander Levin (D-MI), Charles Rangel (D-NY), David Camp (R-MI), and Richard Neal (D-MA) have introduced a bill to reinstate Section 127 retroactively and make it a permanent part of the IRS code.

As an association that represents human resource departments at higher education institutions, CUPA is in a unique position to evaluate the effectiveness and significance of Section 127 benefits, from the perspective as both the providers of educational instruction and human resource professionals.

As higher education professionals, we witness firsthand the usefulness of Section 127 benefits as they are applied by the private sector and their employees to educational pursuits. Like any other benefit, employers are not required to provide Section 127 benefits to their employees. Nevertheless, employers provide these benefits to their employees because they see value and a return on the investment in their employees' education. Employees use Section 127 benefits to keep current with changing trends in rapidly advancing fields such as engineering and computer programming, to broaden their skills and knowledge, and to improve basic reading, writing, or mathematical skills, if necessary.

Finally, as evidenced during the last economic recession, the utility, value, and flexibility of Section 127 was demonstrated readily. Companies that endured layoffs offered Section 127

benefits as outreach programs to their laid-off workers. Many of these employees were retrained for other positions with their current employer or for other employment opportunities within the community. In instances when Section 127 expires and the benefits are taxable, these unemployed individuals who receive these benefits cannot afford to pay taxes on them out of the unemployment compensation they receive. This situation discourages the laid-off employees from receiving the very training they need to rejoin the work force.

We see the significance of offering these benefits to employees to continue their education. College and universities have a difficult time competing with the private sector for employees in terms of compensation. Our members have found that Section 127 benefits are an effective recruiting method for prospective employees who might otherwise choose to work in the more highly compensated private sector. Like their counter parts in the private sector, higher education institutions also realize how important educational assistance is as an investment in human capital. By offering Section 127 benefits, the institutions receive a better-skilled, better-educated employee.

Temporary extensions of Section 127 lead to a great deal of uncertainty in the tax code. Individual recipients of Section 127 benefits -- as well as employers -- encounter the tax implication of this uncertainty every year as they wonder whether Congress once again will temporarily extend Section 127 or make it permanent. Consequently, many employees who would like to continue their education through Section 127 benefits curtail or terminate their education. When Section 127 expires, employers still may offer educational assistance but must include the dollar value of the benefit in the individual's compensation, which makes it subject to federal and state income tax withholding as well as social security and Medicare Hospital Insurance taxes. As a result of the inclusion of the benefits in their compensation, many employees must terminate their continuing educational pursuits because of tax liability.

While reviewing the role of the federal government in the workplace, Congress should consider that the one vehicle that encourages employer investment and assistance toward the goal of providing educational assistance to workers is not a permanent section of the Internal Revenue Code. The continued uncertainty in the tax code regarding Section 127 benefits is an impediment to employers who want to provide worker training and educational assistance. It is essential that Congress makes Section 127 permanent.

CUPA fully appreciates the deficit problems that face this country and the difficult choices that must be made in the budgetary process to determine which programs will be funded and which ones will be eliminated. Section 127 Educational Assistance benefits are a prudent and an economically sound investment in the workforce of this country. The result of this investment in human capital will be a better educated and more technically skilled worker who will help America's economy to compete internationally. The continued education and development of the U.S. worker are fundamental to meeting the challenges of the international marketplace. CUPA urges Congress to make a sound commitment to the continued education of the U.S. work force by making Section 127 of the Internal Revenue Code permanent.

**SUBMITTED STATEMENT OF
THE COMMUNICATIONS WORKERS OF AMERICA
TO THE SUBCOMMITTEE ON OVERSIGHT OF THE
HOUSE WAYS AND MEANS COMMITTEE
ON THE TAX EXCLUSION FOR
EMPLOYER-PROVIDED EDUCATIONAL ASSISTANCE**

The Communications Workers of America (CWA), a labor union representing more than 600,000 working men and women in the telecommunications, printing, and broadcasting industries and in the public sector, wishes to add its voice to those organizations that have testified in support of Section 127 of the Internal Revenue Code, which allows workers to receive up to $5,250 of tax-free, employer-provided educational expenses.

CWA respectfully requests the permanent extension of Section 127, retroactive to December 31, 1994. Over the years this section of the tax code has been shown to be a proven means for the education, training and retraining of American workers.

Our own union has used this tax exclusion extensively since its enactment. To date, workers represented by CWA in such telecommunications companies as AT&T, Ameritech, Bell South, U.S. West, Cincinnati Bell, Bell Atlantic and NYNEX have all improved their skills through use of the exclusion.

We have found it to be an invaluable tool which contributes to American productivity and competitiveness in the global marketplace. This tax exclusion helps our union members to acquire additional skills so they can maintain future employment security in new fields and new occupations, whether inside or outside the companies we represent.

To give some examples:

In 1994, in the U.S. West "Pathways to the Future" program, **13,283** employees used the exclusion to enroll in at least one course or program during the year. This represents approximately **27 percent** of the employees eligible. The enrollment-related expenditures (tuition, required fees and books) totaled **$13,587,644.**

During the life of the program, January 1993 through December 1994, **17,588** employees (**36 percent** of those eligible as of January, 1994) have enrolled in at least one course or program during this period. Related expenditures for tuition, fees and books totaled **$23,763,821**, or an average of **$1,351** per student.

It is interesting to note that since January 1, 1995, when Section 127 expired, there has been a dramatic drop in enrollments at U.S. West.

At AT&T, a program has been developed in conjunction with CWA and the International Brotherhood of Electrical Workers (IBEW), called, "The Alliance for Employee Growth and Development".

Funded by AT&T, and jointly administered by the company and its two unions, the program covered **2,909** active AT&T bargained-for employees and **2,140** laid-off AT&T bargained-for employees during the period from May 1, 1994 through April 30,1995. The Alliance paid out **$3,096,158** for tuition, fees and books to help in the training and retraining of these workers.

The bottom line is that this is one part of the tax code that works. The telecommunications industry is constantly undergoing change. In order for its workers to keep productive in this world of new technology and change, they must be constantly trained and retrained.

The world of telecommunications is also highly competitive. We estimate that since the break-up of AT&T in 1984, hundreds of thousands of workers have lost their jobs because of bottom line downsizing by AT&T and the Bell telephone companies. Retraining programs based on Section 127 have enabled tens of thousands of these workers attain the new skills they need to go on to other jobs, and thus not become a burden upon society.

For these and many other reasons, the Communications Workers of America (CWA) urges the subcommittee to extend Section 127 on a permanent basis, and make it retroactive to December 31, 1994.

Connecticut Farm Bureau Association, Inc.

FOR THE RECORD
Permanent Extension of H-2A - FUTA Tax Exemption

Subcommittee on Oversight
House Ways and Means Committee

Dear Chairwoman Johnson and Subcommittee Members:

On behalf of 4000 members families of the Connecticut Farm Bureau, and more than one hundred Connecticut farms that utilize the H-2A program, I urge your consideration in making permanent the exemption from the provisions of the Federal Unemployment Tax Act for wages of H-2A employees.

H-2A workers are admitted to the United States under Section 101(a)(15)(H)(2)(a) of the Immigration and Nationality Act to perform agricultural labor for limited periods of time. H-2A workers are employed across the United States. In Connecticut, H-2A workers are employed by farmers that produce apples, vegetables and tobacco.

The vast majority of Connecticut farms that employ H-2A workers are family farms. Though H-2A workers are employed throughout the growing season, the greatest number are employed during the critical harvest season, especially for the apple harvest. Without H-2A workers, many of these farms would not survive due to the scarcity of a trained and motivated local labor supply which is within economic means of the farm enterprise.

The permanent extension of the FUTA exemption is crucial to the farms involved in the H-2A program, because it is one of the factors that helps maintain the costs of the program within economic reason for the Connecticut farmer. If farmers using H-2A workers were not exempt from FUTA, federal, as well as state unemployment taxes would increase and result in a significant negative impact upon Connecticut producers. These increased costs would be especially burdensome in Connecticut. Connecticut producers already face one of the highest costs of doing business in the nation. Unfortunately, very few of these high or increased costs can be passed onto the consumer, because Connecticut farm products face stiff national and international competition where farm production costs are generally much lower.

Connecticut agriculture needs the H-2A program as well as a permanent exemption from FUTA in these regards. Your positive consideration of our request would be greatly appreciated.

Sincerely,

Norma O'Leary

Norma O'Leary
President

The Honorable Michael D. Crapo, M.C.
TESTIMONY BEFORE THE
HOUSE WAYS AND MEANS COMMITTEE
SUBCOMMITTEE ON OVERSIGHT
HEARING ON TAX EXEMPTION EXTENSIONS
FEDERAL UNEMPLOYMENT TAX (FUTA)

Tuesday, May 9, 1995

RE: RENEWAL OF FEDERAL UNEMPLOYMENT TAX ACT EXEMPTION FOR H-2A AGRICULTURAL WORKERS

Chairman [Nancy] Johnson, Ranking Member Robert Matsui, and distinguished Members of the Subcommittee on Oversight, I appreciate the opportunity to testify today concerning the need to renew the Federal Unemployment Tax Act (FUTA) exemption for H-2A agricultural workers.

The H-2A program (administered by the Immigration and Naturalization Service) brings in foreign temporary workers under Section 101(a)(15)(H)(ii)(a) of the Immigration and Nationality Act to perform specific jobs. Without this exemption, these workers would be forced to return home to their own country since they are here under contract to do one specific job. As of December 31, 1994 this exemption once again has terminated, and needs to be renewed retroactively to January 1, 1995. Employers are concerned that paying these federal (and state) unemployment taxes for H-2(A) workers would be an undue burden. I have previously submitted a letter this year to the Subcommittee on Human Resources on this matter, and again appreciate Chairman Johnson's gracious consideration and the cooperation of her Oversight Subcommittee on my requests.

It is my hope that the House Ways and Means Committee will agree with my position and the position of many sheepherders in Idaho in permanently extending the FUTA exemption for H-2A for agricultural workers. Thank you for your consideration of this meritorious extension proposal and I look forward to working with Members of the Ways and Means Committee in furthering this extension.

IDAHO FARM BUREAU FEDERATION

FOR THE RECORD
STATEMENT OF THE IDAHO FARM BUREAU FEDERATION
Re: FUTA/H-2A Exemption

May 16, 1995

United States House of Representatives
Ways and Means Subcommittee on Oversight

Madam Chairman and Members of the Subcommittee:

The Idaho Farm Bureau Federation strongly supports the permanent exemption of H-2A workers from the Federal Unemployment Tax Act (FUTA). When Unemployment Insurance (UI) was created by Title III of the Social Security Act of 1935, agricultural employers were specifically excluded. The law was amended in 1976 to include certain agricultural employers. However, **temporary agricultural workers admitted to the United States under the H-2A program were exempted and have been on four other occasions since that time.** The most recent exemption expired January 1, 1995.

The IFBF supports a **permanent FUTA exemption for H-2A workers** for the following reasons:

1. H-2A non-immigrant alien workers are admitted to the United States only for the period of their specific work contract.
2. H-2A workers **must return home at the end of the employment period** and cannot meet the "ready, willing, and available to work" statutory requirement of unemployment insurance.
3. The current situation has placed agricultural employers in the position of collecting and paying payroll taxes for benefits their employees will never receive.
4. There are only 17,000-19,000 H-2A workers in the United States. Total estimated revenue is $816,000-840,000.
5. Imposition of a FUTA tax for H-2A workers increases the regulatory burden for farmers and creates additional indirect record keeping costs for the farmer as well as the federal government.

The American Farm Bureau Federation represents 4.4 million member families and specifically opposes the deduction of federal unemployment taxes from the wages of H-2A workers. The 45,000 member family Idaho Farm Bureau Federation's policy recognizes the unique nature of agricultural employment and is consistent with the AFBF's position. It is for these reasons that **we respectfully request that Congress make the H-2A/FUTA tax exemption permanent**.

Respectfully submitted,

Dennis Tanikuni
Assistant Director of Public Affairs

INDEPENDENT PILOTS ASSOCIATION

May 22, 1995

The Honorable Bill Archer
Chairman
House Ways and Means Committee
1102 Longworth House Office Bldg.
Washington DC 20515

Dear Chairman Archer:

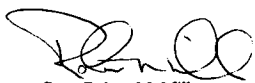
The Independent Pilots Association (IPA), the labor union representing over 1,800 airline pilots flying for United Parcel Service (UPS), writes in support of extending the commercial aviation fuel tax scheduled to be imposed on October 1 of this year. The airline industry has lost more than $13 billion since 1990, and the imposition of the fuel tax this year will likely cause greater financial losses.

The Omnibus Budget Reconciliation Act of 1993 requires the aviation industry to pay a 4.3 cents per gallon tax on jet fuel beginning in October unless an extension is granted. This fuel tax will cost U.S. airlines more than $527 million annually. For UPS in particular, it will cost approximately $15 million annually. Already the airline industry pays approximately $6.5 billion in Federally-mandated taxes and fees. To mandate and further burden the industry with an additional tax is unfair.

Nearly 120,000 airline employees and 125,000 aircraft manufacturing employees in the U .S. have lost their jobs since 1990. Further taxing an industry that is operating on thin profit margins will result in additional job losses. In addition, a fuel tax that costs the airline industry more money will hurt employees who have already given wage and benefit concessions.

As the airline industry continues to struggle to maintain profitability, it makes no sense to burden the industry and its employees with a tax increase. The IPA respectfully requests your support for extending the aviation fuel tax exemption.

Sincerely,



Capt. Robert M. Miller
President, IPA

THE IMPACT OF TARGETED JOBS TAX CREDIT ON EMPLOYMENT OPPORTUNITIES FOR PERSONS WITH DISABILITIES

Written Testimony Presented to the House Committee
On Ways and Means United States Congress
by Steve Zivolich

May 9, 1995

This written testimony will address the critical impact of the TJTC program on employment opportunities for persons with significant disabilities.

Integrated Resources Institute

Integrated Resources Institute (IRI), is a national non-profit agency that was established in 1988 to provide research, educational support and technical assistance to businesses and government agencies developing innovative employment opportunities for persons with disabilities.

Since it was founded, IRI has been instrumental in creating more than 15,000 job opportunities for workers with disabilities. These employment efforts have been accomplished with the active collaboration of three corporate partners: Pizza Hut Inc., Brinker International, and Restaurant Management Company. The employment outcomes and research were also fostered by grants from the U.S. Department of Education: Projects With Industry, Social Security Administration, Health and Human Services, and the Department of Labor.

It is our experience that these 15,000 jobs and related corporate commitments are a dramatic demonstration of the positive impact of TJTC. The Pizza Hut program initiative to hire persons with disabilities (Jobs Plus) began in 1988, four years prior to the passage of the ADA. TJTC was and is the primary reinforcement for Pizza Hut and these other national corporations to engage in this innovative employment effort. As a result, Pizza Hut is not only one of the largest users of TJTC, it is also the largest employer of persons with significant disabilities in the nation.

IRI's experience in designing and coordinating these corporate employment initiatives has convinced us that TJTC must be renewed to continue these positive employment opportunities for persons with disabilities.

Highest Unemployment Rate

Persons with disabilities represent at least 10% of TJTC participants under the categories of Disabled Veterans, Vocational Rehabilitation, and SSI/SSDI. In addition, the unemployment rate for 19.1 million working age persons with disabilities is estimated at 66% by the most recent Harris and associates national survey of 1994. For persons with significant disabilities (those likely to qualify under current TJTC regulations), the rate of unemployment is known to be even higher. For example, the unemployment rates for 1.9 million developmentally disabled working age individuals have been estimated at 87% (Kiernan and Stark, 1989).

According to Census Bureau data, the unemployment trend for persons with disabilities is not improving. For example, between 1980 and 1988 the proportions of working-disabled men, aged 16 to 24 years, working full-time, declined, while the unemployment rate steadily increased. As a result, the

ratio of earnings between men with disabilities and men without also fell. Similar changes were also reported for women of working age. After substantial relative gains in the 1960s and 1970s, persons with disabilities are losing economic ground in the 1980s and 1990s (Yelin, 1991). At the same time, the survey conducted by Harris and Associates documented the strength of this group's desire to work, and their frustrations about barriers to employment (Harris, 1994). In that survey, 79% of the respondents indicated that they would like to work if given the opportunity.

After three years of ADA implementation, disabled advocates realize that there has been no perceivable increase in hiring patterns by private industry. The majority of ADA litigation and employer focus has been directed to current employees with back injuries, filing complaints related to termination and accommodations. ADA is essentially a poorly funded EEOC sanctioning effort, that has little if any positive impact on the employment rate for persons with disabilities. I am not proposing that ADA is not essential to the long term Congressional goal of eliminating employment discrimination toward persons with disabilities. Rather, I am pointing out the importance of having a program like TJTC that rewards the private sector for doing the right thing, that is hiring persons with disabilities, rather than assuming that the remote possibility of punishment under ADA will really have the desired effect alone.

The cost of unemployment to U.S. taxpayers for persons with significant disabilities in SSI/SSDI and medical payments alone exceeds $57 billion each year. Of the 2.2 million SSI recipients with significant disabilities, only 172,000 or 8% are working. Social security further reports that less than 1/2 of 1% of these potential workers return to the labor force annually (Social Security Administration, 1991). In addition, SSI claims based on disability have increased by 20% since 1984, which demonstrates the lack of control on expenditure growth for a welfare approach to disabilities.

SSI was developed 17 years ago to insure persons with significant disabilities maintained an economic income above the poverty level. However, at this time, SSI benefit levels are substantially below the federal poverty level. As one state administrator commented at an SSI public meeting "...the SSI Program is simply inadequate to meet basic human needs (food, shelter, clothing, etc.)..." (SSA, 1991).

As a positive alternative to SSI and welfare the TJTC program has helped IRI to develop corporate employment programs such as "Jobs Plus" with Pizza Hut Inc., Restaurant Management Company and "TeamWorks" with Brinker International. Both Pizza Hut and Brinker have now received the National Employer of the Year Award from the President's Committee on Employment for Persons with Disabilities. The Pizza Hut Jobs Plus program alone is recognized as the most successful corporate effort to date, with more than 14,000 TJTC incentive disability placements since 1988. These TJTC corporate efforts were mentored by the OSER supported employment initiatives, and Projects With Industry and are now a significant component of federal, state, and local agency emphasis and services. The success of the

RSA federal initiative and TJTC is evident through several other significant corporate initiatives such as Marriott and McDonalds.

These private sector, corporate led efforts rely heavily on a public funded supported employment training strategy, as well as Targeted Job Tax Credit (TJTC). Rehabilitation advocates have reported that TJTC has helped offset some of the additional support employees with disabilities require from employers. As a result, the rehabilitation field believes that TJTC has had a significant positive effect on hiring (ARC, 1993).

Comparative Benefit-Cost Analysis of TJTC

In 1991 we concluded a two-year economic evaluation study comparing the resource costs and pecuniary outcomes of a TJTC employment program serving individuals with significant disabilities for the Social Security Administration.

The research focused on the benefit - cost of placing and supporting TJTC and SSI eligible persons with significant disabilities into employment.

The economic analysis utilized was an ex post facto evaluation study analyzing the costs and pecuniary outcomes of an employment program serving individuals experiencing significant disabilities in Pizza Hut over two years.

Characteristics of Sample Population

Fifty-nine TJTC participants from 10 states were included in the Job Plus Mentor (JPM) program sample. Inclusion in the evaluation study was based on entry and participation in the program between July 1, 1990 and January 31, 1991 (a six month period). Seventy-five percent of the participants were identified with some level of intellectual disability, while the remaining 25% were described in terms of other primary disabilities. The majority of participants (67%) did not finish high school, with 33% attending 12 or more years of school. Seventy-eight percent of the sample were Caucasian, 9% African American, and 7% Hispanic. The majority of JPM participants (84%) received SSI only, while the remaining 16% received SSI and/or SSDI benefits.

Collection of Cost Data:

Costs for the JPM program were collected on a program expenditure basis. Costs that may have been incurred through employer tax credit programs (TJTC) were also reviewed. All JPM employers participated in Target Job Tax Credit subsidies and received, on the average, $1,415 per client.

Collection of Benefit Data (Pecuniary):

According to Benson (1978), Cohen (1979), Gramlich (1981) and Taggart (1981), employment earnings are used as the major pecuniary outcome measure in employment and training benefit-cost research. In response to this convention, benefits for the study were based on wages earned for hours employed. Due to the impact of earnings data on subsequent taxes paid and reductions in welfare (transfer) payments, these latter categories were also assessed as benefits associated with each of the employment options in the study (Thornton, 1985; Collignon, Dodson, & Root, 1977; Dodson, 1979; Hill & Wehman, 1983).

Data Reduction:

Cost data from the program were converted into mean cost per worker. Program outcomes (benefits) were initially transformed into five categories: 1.) average hours worked per week, 2.) average hours worked per month, 3). average hourly wage, 4.) monthly earnings, and 5.) annual gross earnings. From these data two additional categories were added to the analysis: 6.) State and federal taxes paid on gross earnings and 7.)reductions in Supplemental Security Income (SSI) due to monthly wages.

Tax calculations were assessed at 23% of annual gross earnings. This percentage was initially established by Pechman and Okner (1974) and subsequently used by Thornton (1985), Hill, Hill, Wehman, and Banks (1985) in determining annual state and federal taxes paid by low wage earners with disabilities.

Reductions in welfare payments were computed using the SSI's standard income adjustment formula for earned income. Tax and SSI reduction formula were applied to the earnings of each participant in the JPM programs.

Rationale for Configuring Costs and Benefits:

Program costs are viewed as no cost to the participant but clearly translate into costs for taxpayers and society. Earnings benefit the participant, have no effect on the taxpayer, but when both perspectives are totaled, they equal a benefit to society. State and Federal taxes are a cost to the participant but a benefit to the taxpayer. By totaling these perspectives, the benefits and costs nullify each other, having zero impact on society at large.

Determining the benefit or cost status of Supplemental Security Income (SSI) reductions from the three perspectives is somewhat more complex. When SSI payments are reduced due to wages earned from work, this translates into a reduction of income that would have been available if the participant had not worked. Therefore, the reduction in SSI is seen as a cost to

the participant. From the taxpayer's perspective, the reduction is seen as a benefit in two ways: First, the amount of the reduced payment is a tax savings, and second, the cost of administering those funds is also saved. Thus, the taxpayer's benefit is computed by adding the reduction in SSI to the savings in administrative costs (Barnett, 1985; Thornton, 1985). From society's perspective, the reduced SSI payment is viewed as a transfer of funds from one group of people in society (the participants in the study) to another group (other welfare recipients). Hence, the reduction in SSI payments is just a shift of funds (transfer payment) and does not constitute a savings to the society as a whole. In contrast, society observes the obviated administrative costs for SSI as a savings in actual resources. Therefore, the latter are observed as a benefit to society (Barnett, 1985; Thornton, 1985).

Results: Benefit-cost Analysis:

Individuals in JPM programs benefited $1,584 annually from their participation in this TJTC model. The benefit-cost ratio for the taxpayer's investment in JPM programs equaled .74, while the ratio from society's perspective was 1.21. Thus, for every taxpayer dollar invested in JPM participants, taxpayers realized a return of 74 ¢ and society $1.21, see (Table 1).

Table 1: JPM Program Analysis:

Job Plus Mentor Program (Program B-C Analysis)			
Component	**Participant**	**Taxpayer**	**Society**
Benefits (Pecuniary)			
A. Outputs			
1. Gross Earnings	$3,978	0	$3,978
2. State & Federal Taxes	($915)	$915	0
B. Reduced Dependence On Transfer Programs (SSI)			
1. Reduction In SSI	($1,479)	$1,479	0
2. Reduction In Admin. Costs	0	$148	$148
Total Annual Benefits/Person	$1,584	$2,542	$4,126
Costs (Pecuniary)			
A. Inputs			
1. Total Annual Cost/Person	0	$2,006	$2,006
2. Target Job Tax Credit	0	$1,415	$1,415
Total Annual Cost/Person	0	$3,421	$3,421
Benefit-Cost Ratio		0.74	1.21

The benefit-cost research clearly indicates, TJTC dollars invested in the Jobs Plus program as substantially efficient. From participant, taxpayer, and society perspectives, this translates into increased levels of productivity which were not realized when greater resources were spent on individuals receiving welfare, (SSI) approaches.

Clients with significant disabilities in the Jobs Plus program experienced increased benefits by choosing to participate in the Jobs Plus program as opposed to welfare. From a public policy perspective, the Jobs Plus program clearly satisfies Cohn's (1979) criteria for public funding (B/C > 1). The return to society exceeds the point of parity for each TJTC dollar invested. These data provide a sound rationale for public support of the TJTC program.

Clearly, the programmatic strategies utilized by the Pizza Hut TJTC model reflect substantive improvement in maximizing the economic efficiency of each TJTC dollar spent on employment activities for persons with disabilities.

Benefits to Participants with Disabilities

The benefit-cost data presented is compelling in terms of describing the potential effects of TJTC policy decisions on the earning power of individuals with significant disabilities, their marketability in competitive labor markets, and the fiscal impact of habilitation decisions on taxpayers and society at large.

Three Year TJTC Survey

Through 1989 to 1991 we surveyed 4,972 TJTC employees with disabilities hired by Pizza Hut. The results indicated dramatic increases in employment opportunity, wages and tenure.

74.9% of the workers reported that they had been unemployed for the previous 6 months prior to their job with Pizza Hut. For the majority of these workers it was also their first job ever, as well as their first pay check.

The average weekly wage for these TJTC hires was a 104% increase over their previous reported wage income.

The annual turnover rate for TJTC hires was tracked at 29%, which is five times superior to non-TJTC co-workers turnover which was 170% for the same period.

Recommendations

The Pizza Hut, Brinker, and RMC TJTC programs for persons with disabilities are providing a necessary bridge between publicly funded rehabilitation programs and privately supported employee assistance programs in corporate institutions. These private sector demonstrations of TJTC programs are establishing an economically efficient and programmatically sound model for emerging public and private industry partnerships.

The conceptual framework for the TJTC programs could undoubtedly serve as a model for private industry to begin assuming the primary responsibility for post-school employment training of individuals with significant disabilities, if Congress would implement the following programmatic changes.

√ **TJTC should be made a permanent tax statute to avoid private sector reluctance associated with termination dates and the doubt of renewal.** Employers often take a wait and see attitude regarding renewal which reduces hiring activity.

√ **Develop a standardized one page TJTC authorization form for all State employment certification sources to utilize.** Currently there are 50 different

forms in use, which unduly burdens multi-state employers from implementing the program.

√ **Expand the TJTC program to all persons with disabilities.** Currently the program requires persons to be registered with their state rehabilitation agency or SSA. However, only 10% of persons with disabilities who are structurally unemployed are registered with state rehabilitation or receive SSA support.

Summary

The TJTC program had provided a necessary incentive as a bridge between publicly funded rehabilitation programs and privately supported employee assistance programs in many corporate institutions.

TJTC programs have established an economically efficient and programmatically sound model for emerging public and private industry partnerships to employed persons with disabilities. The framework of the TJTC program could undoubtedly serve as a model for private industry to expand it's TJTC efforts and begin assuming the primary responsibility for employment training of individuals with significant disabilities.

These efforts have the potential to have an even greater impact on the reduction of structural unemployment, if the program expands to all persons with disabilities and implements the efficiency strategies that have been recommended.

Structurally Unemployed

Persons with disabilities represent 10% of all TJTC authorizations. They also have the highest unemployment rate of any identified minority group.

Employment Opportunities to the Disadvantaged

TJTC jobs are providing essential initial job training and career opportunities to persons with significant disabilities who are essentially unskilled. The TJTC opportunities present the most efficient training possible for this population, by teaching job skills on the job.

Employers to Seek Out and Hire the Disadvantaged

The TJTC program is an essential component to reaching the ADA goals of employment and elimination of discrimination for workers with disabilities. Employment opportunities for disadvantaged individuals with significant disabilities have been driven in large part by TJTC.

Cost Effective Outcomes for Society

Our research indicates a positive return to taxpayers for each TJTC hire in the first year. In addition, the superior retention rate and on the job training opportunities further supports this taxpayer investment for workers with disabilities.

Improved Income, Training, and Retention

TJTC has dramatically impacted employment, wages, training and retention rates for persons with disabilities.

Thank you for the opportunity to share my written observations of a federal tax incentive program that is highly effective in its multiple goals that benefit: taxpayers, employers, employees with disabilities and our country.

I urge you, on behalf of the 9.9 million unemployed Americans with disabilities who have stated that they want to work, if just given the chance, to re-authorize, expand, and make TJTC a permanent tax credit.

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STATEMENTS OF INTERNATIONAL UNION, UNITED AUTOMOBILE, AEROSPACE & AGRICULTURAL IMPLEMENT WORKERS OF AMERICA (UAW), AND UAW-GM LEGAL SERVICES PLAN, UAW-FORD LEGAL SERVICES PLAN, UAW-AAI LEGAL SERVICES PLAN

The International Union, United Automobile, Aerospace & Agricultural Implement Workers of America (UAW) and the UAW Legal Services Plans (UAW-GM Legal Services Plan, UAW-Ford Legal Services Plan, UAW-Chrysler Legal Services Plan, and UAW-AAI Legal Services Plan) submit this statement to the Ways and Means Committee in strong support of H.R. 540 to permanently reinstate Section 120 of the Internal Revenue Code, making the employee benefit of prepaid legal services tax exempt and preserving the access of working and retired families to the legal system.

The Legal Service Plan came into being under the protective umbrella of the Internal Revenue Code Section 120, first enacted in 1976. This law placed prepaid legal services plans funded by employers for their employees on the same footing as other tax exempt employee benefits such as health benefits. The UAW has been in the forefront of the development of prepaid group legal services, with the first operation, UAW Chrysler Legal Services Plan, opening in 1978. For the next ten years, Section 120 expired seven times, each time receiving temporary extensions. However, group legal services continued to gain wide popularity. UAW-GM Legal Services Plan began operations in 1983 and UAW Ford Legal Services Plan began operations in 1985. On June 30, 1992, Section 120 expired and has not been renewed despite vigorous lobbying by unions and prepaid supporters and although 218 members of the House of Representatives co-sponsored a bill to reinstate the exemption. We believe that now is the time to reinstate Section 120 in order to realize Congress' original goal in creating Section 120--extending low cost, quality legal services to middle-income, working and retired Americans--during this period of renewed commitment to providing relief and balance to working and retired people.

Traditionally legal services have only been available to the very rich or the very poor. Average working Americans have been shut out of the legal system, since they did not qualify for legal aid programs and yet were unable to allocate limited financial resources to legal representation. As a result, most middle income Americans simply went without any legal assistance. This began to change after the implementation of Section 120. Unions like the UAW began taking increasing interest in negotiating group legal service plans as a means of assuring that their members have access to quality, low cost representation. Employers also supported legal services plans as they saw that for an extremely modest sum of money per worker, the employees are provided with a means of solving troubling legal issues while remaining productive members of their company.

The Legal Services Plan is now in its sixteenth year of operation. More than 800,000 workers and retirees are covered by our Plans, and when families are included more than two million persons are eligible for services under the Legal Services Plan. Although there are many prepaid plans out there, the UAW Legal Services Plan is the largest and is representative of the types of legal services provided to workers and retirees eligible for this type of benefit. Prepaid legal service plans have proven

themselves to be extremely cost effective and even the most comprehensive plan generally costs less than $100 per year per worker. Unlike many other fringe benefits, costs have not skyrocketed but instead have remained relatively stable throughout the years.

Legal Services Plans provide personal legal services on a variety of legal matters including estate planning, probate, consumer problems, the sale and purchase of homes, credit reporting problems, domestic issues, and other personal legal problems. Without Legal Service Plans, middle income people often cannot afford to see an attorney despite the seriousness of the problem they may be facing. However, prearranged access to an attorney allows people to call on an attorney when they first face the trouble, before it is too late. Because of Plans like the UAW Legal Service Plans, houses need not be lost, cars need not be seized, utilities need not be cut off, and debt problems need not grow into insurmountable problems. Through early identification and intervention, problems can be solved and stopped thereby avoiding costly distractions and disruptions to the worker's job.

The Legal Services Plan is a law firm with more than 400 attorneys, with more than 70 offices, located in the following 18 different states:

Alabama:	2 offices
Delaware:	1 office
Georgia:	2 offices
Illinois:	3 offices
Indiana:	8 offices
Kansas:	1 office
Kentucky:	1 office
Louisiana:	1 office
Maryland:	1 office
Michigan:	27 offices
Minnesota:	1 office
Missouri:	3 offices
New Jersey:	2 offices
New York:	6 offices
Ohio:	15 offices
Oklahoma:	1 office
Texas:	1 office
Wisconsin:	2 offices

In areas where there are not a sufficient number of employees and retirees to warrant establishing a Plan office, a "Cooperating Attorney" system was developed to provide benefits. Plan staff attorneys are dedicated not to serving the business or corporate or political concerns of their clients, but to solving the everyday problems of working and retired families. Our experience supports the idea that if problems are caught early, they can be resolved simply. More than 50% of Plan cases are resolved in two hours or less with advice and counseling to the client who needs help dealing with the system.

Another hallmark of this benefit is estate planning. More than 24% of the cases the Plan handles are for this type of matter. Because working families have access to legal advice, they are able to adequately prepare for their spouse, minor children, and disabled children. Without the legal service benefit, most of these people would not consult a lawyer at the planning stage thereby avoiding numerous problems for their family at their own disability or death. Beginning in August 1990, the UAW Legal Services Plan counseled hundreds of clients as to their legal rights and protection, as these workers prepared to leave for Operation Desert Storm. Wills and powers of attorney were drafted and advice was given to families of soldiers. This type of benefit not only provides tremendous peace of mind to the effected worker, but also provides a real service in terms of reducing or eliminating legal problems at the injury, disability or death of the worker.

At other times, though, Plan clients need more because they are sued or threatened with the loss of a home or another significant injury. Prepaid legal services, like the UAW Legal Service Plans, usually provide in-court representation for these clients who would otherwise give up since they would be unable to pay for the necessary legal services. Typical of these types of cases are the clients who pay contractors significant sums of money to have needed home improvement work completed, only to have no work at all done or shoddy unacceptable work completed. Although our retirees are often the victims of these scams, they are also perpetuated on honest, working people who expected fair work for a fair price.

Prepaid legal services plans assist middle-income Americans at many critical points in their lives. Typical cases handled by prepaid legal services plans include defective consumer purchases, vacation property scams, investments gone wrong, credit reporting problems, guardianships, landlord tenant problems, insurance problems, collection of disputed debts, claims arising out of the sale or purchase of real estate and defense of foreclosures and forfeitures. In 1994, more than 245,000 new cases were opened in Plan staff offices. Another 60,000 referrals were provided to retirees and workers who lived in areas without a Plan staff office. The types of cases handled under these Plans broke down as follows*:

Wills, Probate, and Estate Planning:	24.2%
Real Estate:	24 1%
Consumer cases:	20%
Family and Other Matters:	31.7%

Prepaid legal services for middle income workers and retirees address the historical imbalance that occurs when parties to a dispute are unequal financially. The UAW Legal Services Plan, like other prepaid legal services, has from the beginning sought to correct that imbalance. Without access to a legal service plan, these problems would remain unresolved, regardless of the merits of their case.

*See attachment to this document for a complete listing of Plan cases.

The Joint Committee on Taxation estimates that the revenue loss associated with Section 120 is such a small percentage of the federal budget that it would have no impact on it. However, if Section 120 is not reinstated permanently, the creation of new plans will be discouraged, while benefit dollars are shifted to other tax favored benefits. We will return to the day when middle income working and retired people were all but shut out of the legal system. This is one tax benefit that was truly aimed at working and retired people and which gave this same group of people meaningful access to our legal system. We urge you to support H.R. 540 and to reinstate and make Section 120 permanent

Some comments from our members and clients:

I find this service to be invaluable! I feel secure in contacting the service because I won't be "taken" money-wise. I like knowing that I can trust their services..I feel I can ask her advice before I do something dumb. Thank you. Burr Ridge, Illinois

My wife and I had our wills made out by one of your attorneys and were well satisfied. The second case was a problem between a hospital and me and a collection agency. Once I showed (the attorney) all the bills and receipts, he took over. He sent the agency a letter that he was representing us and all the threatening letters stopped coming. I would not hesitate to use the services any time needed. Burr Ridge, Illinois

Before my husband's death, we used the service for the legal work involved in buying our home. As a surviving spouse, I believe this to be a very valuable service. I don't know the name of the attorney who helped us for this but I do remember he was very helpful in answering our questions and helping us with the contract. Kansas, Missouri

We really feel the plan has been beneficial to us. [The attorney] saved us $2,000 with just a phone call when we purchased our lake lot. He has been most helpful and fact we have the legal service has helped resolve problems quickly. We plan to use the plan to draw up a will and ..a problem with an easement. Kansas, Missouri

I don't know what I would have done had it not been for the UAW lawyers. I have used them for bankruptcy, food stamps for my daughter and grandchildren who live with me am in the process of having my late husband's estate probated. I always look to UAW for help and advice. Oklahoma City, Oklahoma

Any legal matter is a stressful situation. Having an attorney to represent your interests not their bank account is a real relief. It is a valuable service to all UAW employees. Oklahoma City, Oklahoma

I feel this program is one when you need to use it can be invaluable. I don't have any idea how much in legal fees in the past few months I would have spent. I would definitely recommend the Legal Service to other workers who need advice of a legal problem. [My attorney] was a great asset to me through a very difficult time in my life. She provided answers to questions that would affect the rest of my life. I found her to be a great attorney as well as person. She will always have my greatest thanks for the help she gave me. Her answers to questions I had were factual and to the point. She kept me advised at all times and I would go to her for any problem. Anderson, Indiana

I consider the UAW-Ford Legal Services Plan a great benefit and importance in this day and age. It is extremely expensive to get legal help and advice especially being retired. Along with my health benefits it is comforting to know that this program is available. My thanks to UAW and Ford for making life a little easier. Clearwater, Florida

Being on a pension and considering my age, this is a necessary benefit. I could never afford to pay an attorney. In this particular case, the attorney was able to save me approximately $10,000 on the last part of my transaction, which I felt they were trying to swindle me. Attorney [ ] wrote a letter and the other party backed down. Clearwater, Florida.

Without this service that have been instances when a problem would remain a problem due to the cost of an attorney. This service has enabled me to improve my quality of life by having counsel when need to solve or work through situations that you otherwise would have to tolerate. I thank Ford & UAW for this service and would miss if it were not available to me. I hope this service becomes a permanent part of our benefit package. The office staff is responsive to needs presented and have in all cases allowed a workable solution to be found. Louisville, Kentucky

We were both very happy with the services provided. It eased our minds to know our affairs were put in order and especially made easy through the no expense condition from one of many benefits as a Chrysler employee. Thank you for this benefit and I do plan on using it for future needs. Milwaukee, Wisconsin

The UAW legal service is very good in many ways. They assist us so fast and jump right on our case. The lawyers that work for us are honest. This has saved me lots of money and time. Janesville, Wisconsin

I feel the program is worthwhile. I like the feeling I get when I know I can call for opinions on matters that concern me. I handle a lot of problems over the phone. I get comfort to

know I have access to the legal system, without having to come up with retainers. St. Paul, Minnesota

I thank God for the UAW Legal Services Plan, because it has helped me and saved time and money because I don't have to lose a lot of time off my job to handle some legal matters and the attorneys are really helpful in explaining my situations as well as represent me when in need. In my opinion, we couldn't do without this benefit and I don't want to lose it. St. Louis, Missouri

[The attorney] and her assistant were invaluable to me in the process of gaining guardianship of my mother. There were times during the first year that they assisted me when I was unsure of what to do. They have a great staff. St. Louis, Missouri

My income is so low that I can't pay myself so I am very pleased that UAW Chrysler Legal Services Plan Attorneys are available. Detroit, Michigan

I was extremely pleased with the way in which my probate was handled. Things were resolved with excellent legal advice and in a very timely and professional manner. [The attorney] proved to be very resourceful, available and courteous. I can't say enough good things about her. At a very stressful time in my life following my mother's death, she offered both legal and emotional support in a most appropriate manner. Both attorney and assistant were very prompt in returning phone calls and assuring that the case would be expedited. I strongly recommend the GM Legal Services to other UAW members. Thanks again for a job well done. Pontiac, Michigan

I was grateful to use this service upon the death of my husband. It was a great help during a difficult time. Kalamazoo, Michigan

It was unfortunate that legal services were required but [the attorney]'s professionalism certainly made the ordeal easier on my wife and me. Livonia, Michigan

I was very happy with the job that the [the attorney] performed for me. He took me by my hand and without him I would have lost some money. He is also helping us with the contract for the house we are purchasing. He takes his time to explain every question have so that I feel secure in dealing with the real estate. This is one of the best services the UAW has offered. Livonia, Michigan

This service is a great help to us because on a fixed income it's hard to make ends meet Thank you very much. Atlanta, Georgia

Cases Handled by UAW Legal Services Plans 1994

Type of Case	Cases Opened	Percentage
Wills and Trusts	31,415	12.8
Probate of Estates	11,118	4.5
Taxes	413	.2
Civil Commitment	172	.1
Guardianship	6,797	2.8
Power of Attorney	5,774	2.4
Name Change	810	.3
Birth/Marriage Certificate	438	.2
Medical Health Issues	836	.3
Income Tax	982	.4
Federal Taxation	1,643	.7
Divorce	13,572	5.6
Custody and Visitation	4,475	1.8
Support and Alimony	7,368	3.0
Adoption	1,135	.5
Paternity	1,107	.5
Other Family	4,508	1.8
Criminal	5,373	2.2
Drunk Driving	1,814	.7
Other Traffic	4,098	1.7
Juvenile	1,370	.6
Participant as Victim or Witness	820	.3
Social Security	2,577	1.1
Medicare Medicaid	1,198	.5
Unemployment Compensation	334	.1
Workers Compensation	904	.4
Other Public Benefits	153	.1
Employment	3,087	1.3
Education	977	.4
Auto Property Damage	6,632	2.7
Malpractice	1,453	.6
Assault and Battery	360	.2
Property Damage	995	.4
Other Tort	5,945	2.5
Administrative Agencies	1,454	1.2
Real Estate Purchases and Sales	27,483	11.3
Claims from Purchase or Sale	5,938	2.5
Landlord Tenant	4,972	2.0

Deeds	7,034	2.9
Foreclosure	1,847	.8
Taxes or Real Property	1,076	.4
Home Improvement	2,856	1.2
Other Real Estate	7,305	3.0
Collection Suit Against Client	4,918	2.0
Repossession or Garnishment	1,912	.8
Other Debt	5,328	2.2
Bankruptcy	4,757	1.9
Credit	4,600	1.9
Consumer Complaint	19,354	7.9
Insurance Claim or Loss	4,874	2.0
Utilities	524	.2
Client as Creditor	4,277	1.7

Statement of

Arthur A. Coia, President

Laborers' International Union of North America, AFL-CIO

May 9, 1995

The Laborers' International Union strongly supports pending legislation, H.R. 540, which would reinstate the exclusion from employee taxable income of contributions by employers to group legal service plans under Section 120 of the Internal Revenue Code.

Our Union is uniquely qualified to testify on issues affecting this important benefit for workers. Beginning as far back as 1971, in Shreveport, Louisiana, and soon after in Ohio and Massachusetts, we pioneered in the development of group legal services plans in the belief that access to legal services was as important to our members as medical care and pension benefits.

Twenty-four years later, we are convinced that we made the right decision. Thousands of workers every year find that they are able to get competent legal help through negotiated group legal services plans on serious family, financial, housing and consumer problems. Workers whose family incomes would not otherwise allow them the luxury of retaining a lawyer are able through these plans to use the justice system to assert their rights and seek remedies.

What we have been able to accomplish through qualified group legal service plans is precisely what Congress intended when it enacted section 120 in 1976. By placing legal services in the same tax category as other statutory benefits, it established the public policy principle that employers and unions should be encouraged to work out means to make basic legal services available to workers.

Section 120 was originally enacted as a five-year experiment. Policy makers were concerned about whether the benefit would wind up accruing only to highly-paid executives, whether employer contributions would be insufficient to finance the arrangement and whether inflationary pressures would escalate the cost of legal service plans, as has happened in the case of medical care.

But in considering section 120's fate in 1981, Congress agreed that none of these evils manifested themselves during the five-year trial period. In fact, legal service plans were shown to benefit low and moderate income workers on a non-discriminatory basis. The modest funding formula used to finance these plans not only was shown to provide more than adequate financial support, but costs barely increased during the period. In light of this record, Congress extended the provision for three more years, then extended it five more times for shorter periods.

Even in the face of expirations and retroactive reenactments, section 120 served its purpose. There are now approximately 3.2 million employees and retirees covered by qualified group legal service plans at an average cost of under $100 per worker per year. Since these plans also provide access to essential legal services for family members, a total of 7.6 million Americans now benefit from employer-provided legal services.

Employer-paid legal services plans have so clearly proven their value that almost no one opposes them. Everyone agrees they are a good idea and that they work. The only excuse for letting section 120 expire was that the government needed the $85 million per year attributed to section 120. That was a tax increase on middle class Americans and, to a lesser extent (because of Social Security contributions), on enlightened employers who provided this proven benefit. Reinstating section 120 would rescind that tax increase.

Plans Solve Problems.

The legal services plan tax provision excludes from an employee's gross income the first $70 contributed by his employer to a qualified legal services plan. These plans provide advance arrangements for meeting personal legal needs, especially for legal services that prevent or settle disputes. Legal services plans:

>promote individual happiness and family harmony by preventing or resolving serious legal problems

>increase the quality of justice by making legal advice more available to the average citizen

>improve economic productivity, because an employee distracted by legal difficulties isn't fully effective.

Legal services plans enjoy broad, strong support from labor, consumer, bar and insurance groups. There is no opposition to legal services plans. Plans are in the best American tradition of pragmatic, voluntary group action to meet common needs.

Section 120 puts legal services plans on an equal footing with other statutory fringe benefits. Legal services plans benefit primarily middle and working class Americans and are especially popular with union members. Even the most comprehensive plans seldom cost more than $150 per family per year.

Legal services plans exhibit considerable diversity in structure, cost and benefits, depending on the group of people covered--their number, geographic distribution, family situation, etc.--and the funding available.

Plans members receive mainly preventive legal services that often make it possible to avoid litigation or serious or protracted remedial services. Thus, group legal plans tend to preserve employee morale and productivity and assist in unlocking our overburdened judicial system.

Why Plans Work

What is it about legal plans that creates "win-win" situations, where everybody benefits? Basically, it is that transaction costs are reduced when advance arrangements are made on a group basis for providing needed legal services. Advance payment is not as important as advance arrangements that make legal services readily available. These advance arrangements dramatically reduce the time, cost and uncertainty involved in selecting and consulting a lawyer when a legal question arises.

People covered by a plan contact a lawyer more often, but at an earlier point in the course of a problem. More people receive legal advice, about more matters, but matters are handled at lower cost and in a way that minimizes disputes and litigation.

Plans Help Working People.

In enacting section 120 in 1976 Congress meant to encourage more equal access to legal help for middle income Americans. You succeeded. The Treasury's own June 1988 study of legal services plans found that "plans covered by section 120 did provide relatively greater access to legal services to production workers and union members" (than to professional and administrative employees). "(T)his pattern stands in stark contrast to most other kinds of employee benefits, which are relatively less available to production employees." (emphasis added)

Without section 120 a business has an unfair advantage in any dispute with a consumer. The business' legal expenses are deductible but the consumer's are not. The landlord's legal bills are deductible, the tenant's defense of his home is not. Legal services plans offer a way for tenants, consumers and the large majority of Americans to enjoy better access to legal help without the federal government taking the expensive step of making personal legal expenses deductible or vastly expanding federal legal aid.

No Bureaucracy

I must mention that these plans are privately administered. The lawyers who provide services to plan members are mostly in private practice, and all are subject to state rules of practice. The plans themselves are regulated through ERISA like other employee benefit plans.

Tax Increase Threatens Progress

All employees covered by an employer-paid group legal services plan suffered a tax increase when section 120 expired. So did contributing employers, who now have to pay Social Security payroll taxes on their contributions.

Almost as important to employers as the payroll taxes they have to pay is the administrative burden of accounting for the contribution. Consider, for instance, plans covering retired workers. Retired employees now incur a tax liability for contributions made on their behalf by their former employers, who are required to issue W-2 or 1099 forms for them.

So far, few existing plans have been terminated because section 120 expired, but as plans come up for renegotiation in a period of tough global competition, health care cost pressures and static wages, the taxability of legal services plan contributions can only work against them compared to tax-favored benefits.

Section 120's expiration has also deterred additional employers from beginning to offer group legal service benefits, given that other non-taxable benefits are readily available. Where taxable group legal service benefits are offered in a flexible benefit plan, they have been in some instances slighted in favor of other non-taxable benefit options.

State income tax ramifications are also important. Many states' personal income tax laws follow federal income tax exclusions. Since section 120 expired, employees in those states effectively have seen an increase in their state income taxes.

Tax Revenue Insignificant

While the current taxability of plan contributions threatens their future, it is producing insignificant tax revenue to the federal government. The Joint Committee on Taxation's latest estimate was that letting Section 120 expire would produce $85 million in revenue, an infinitesimal percentage of the federal budget. Even that estimate is too high, because it ignores shifts in contributions that are already occurring from legal services plans to health benefits and others that remain tax-exempt.

In conclusion, Congress should rescind the back door increase on middle class Americans resulting from the expiration of Section 120 and reinstate the Congressional policy of encouraging private efforts to achieve justice more efficiently for the average citizen.

The Louise and Claude Rosenberg, Jr. Family Foundation

Phillip D. Moseley, Chief of Staff, Committee on Ways and Means

Reference: Statements re Gifts of Publicly-Traded Stock to Private Foundations

My name is Claude Rosenberg, Jr., and I am writing on behalf of myself and my wife, Louise J. Rosenberg. I am a registered Investment Advisor, founder of RCM Capital Management of San Francisco, California, managers of (mainly) institutional monies of over $20 billion invested in common stocks and bonds. I have over forty years of experience in the investment field, have authored four books on investing, and am the author of a well-accepted book on philanthropy, entitled *Wealthy and Wise: How You and America Can Get the Most Out of Your Giving* (Little, Brown & Co., published October, 1994). My wife and I are strongly-committed advocates of, and participants in, philanthropy through both personal contributions and involvements and through a private foundation, The Louise and Claude Rosenberg Family Foundation, which we formed December 23, 1986. It is important to state that we plan to continue supplementing our foundation giving through significant personal charitable contributions, and that we would benefit from the deductibility from the use of appreciated securities--hence, the recommendations made herein would be costly to us personally.

While we favor the *general* use of readily marketable stock at full market value as tax-deductible contributions to private nonoperating foundations, we believe that new regulations that will ensure enhanced use of such funds to worthwhile causes should accompany a restitution of full market value benefits to contributors. Our position, described specifically below, is motivated by the following: a) that serious social ills permeate our nation; b) that a significant decline in funds to certain social needs will occur in our (proper) quest for the elimination of waste from government expenditures; c) that transfer of funds from Federal to state governments, while preferable, will not provide the necessary solutions to our social problems; d) that the private sector can accomplish "more with less" than the public sector in many endeavors now dominated by government; and e) that enhanced philanthropic contributions, combined with the amazing volunteer force already serving the nonprofit sector, constitutes the most efficient and most desireable way to alleviate, and in many cases eliminate, many of our nation's worst social problems.

Despite these facts and this reasoning, we contend that allowing private nonoperating foundations to be bolstered anew through *the use of fully deductible gifts at market price would be shortsighted without encouraging greater and more imminent use of such funds than the current mandated five percent (pre-operating and related expenses) of corpus rule.* **The five percent payout may give our government(s) a fair return when donations are made in cash, but the costs to government(s) from allowing the avoidance of capital gain taxes along with a five percent payout seem less fair. This is especially important to consider because of America's serious deficits (Federal, along with many states and local communities), as well as the existence of the**

aforementioned debilitating social conditions of our nation. *In short, our government should become more certain that more critical improvements to our society result from private foundation efforts than has been the case. Our government should encourage a new wave of responsible philanthropy that should favorably alter charitable donations and lead to a highly positve trend for volunteerism, as well as an enhanced spirit of cooperation amongst our citizenry.*

Our proposed rules are divided into two parts: first, pertaining to **new contributions to private foundations**; and second, to **existing money within such entities.**:

New Contributions to Private Foundations: Tax deductibility of donations should be tied to two factors: first, to the amount of capital appreciation (market value versus original cost) of the donated asset; and second, to the subsequent payout ratio to be made by the donor's foundation from such asset. The higher the percentage of market value over cost, the higher the required subsequent donation payout ratio (and vice versa). Thus, a donated common stock that carries a 99 percent gain over its cost would receive little or no deductibility under a 5 percent payout plan, but it would receive full deductibility if it were segregated into a new entity within the recipient private foundation and become committed to, say, a 50 percent payout. Likewise, a donated stock with a 50 percent gain over its cost might require perhaps a 25 percent annual payout to receive its full deductibility as a gift.

This suggestion should be considered as a temporary encouragement for more money to flow to the private sector at this particular time. As our country's social and financial conditions improve, it would be hoped that terms would become more favorable for giving, with less restrictions on the use of appreciated securities. **Still, the concept of relating tax deductibility to the amount of appreciation of assets donated, along with donor choice of payout ratio, seems valid and eminently fair to all parties.**

Existing Money in Private Foundations. Legislators must be careful not to tamper unnecessarily with the five percent payout mandated from private foundation *existing assets*. Protection of purchasing power (being hedged against inflation) is important for foundations as it is for individuals. Despite this warning, study should be made to determine whether increased payouts *from existing assets* can be encouraged in the event of significant (well above average) asset growth within private foundation portfolios. Foundation personnel, including original donors, should not lose sight of the principal missions of their institutions: To provide opportunity for those to which opportunity is not readily available; To foster greater accomplishments from the private sector; To benefit America through its unique system of free enterprise supplemented by associations of private citizens willing to cooperate and make reasonable sacrifices for the good of the whole.

Thank you for your consideration of these recommendations. Respectfully submitted,

Claude Rosenberg, Jr. Louise J. Rosenberg

The Louise and Claude Rosenberg, Jr. Family Foundation

Supplemental Sheet to statements made by Louise J. Rosenberg and Claude Rosenberg, Jr. in letter to Phillip D. Mosely, Chief of Staff, Committee on Way and Means, on May 20, 1995, subject "Statements re Gifts of Publicly-Traded Stock to Private Foundations."

1. Writers of the above document, Louise J. Rosenberg and Claude Rosenberg, Jr., can be reached at:

2465 Pacific Avenue, San Francisco, CA 94115
Home phone: 1 415 563 8444
Office phone: 1 415 954 5441; Fax: 1 415 954 8201

2. Summary of comments and recommendations:

While we favor the *general* use of readily marketable stock at full market value as tax-deductible contributions to private nonoperating foundations, we believe that new regulations that will ensure enhanced use of such funds to worthwhile causes should accompany a restitution of full market value benefits to contributors.

We contend that allowing private nonoperating foundations to be bolstered anew through *the use of fully deductible gifts at market price would be shortsighted without encouraging greater and more imminent use of such funds than the current mandated five percent (pre-operating and related expenses) of corpus rule.* **The five percent payout may give our government(s) a fair return when donations are made in cash, but the costs to government(s) from allowing the avoidance of capital gain taxes along with a five percent payout seem less fair. This is especially important to consider because of America's serious deficits (Federal, along with many states and local communities), as well as the existence of the present debilitating social conditions of our nation.** *In short, our government should become more certain that more critical improvements to our society result from private foundation efforts than has been the case. Our government should encourage a new wave of responsible philanthropy that should favorably alter charitable donations and lead to a highly positve trend for volunteerism, as well as an enhanced spirit of cooperation amongst our citizenry.*

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percent gain over its cost might require perhaps a 25 percent annual payout to receive its full deductibility as a gift.

This suggestion should be considered as a temporary encouragement for more money to flow to the private sector at this particular time. As our country's social and financial conditions improve, it would be hoped that terms would become more favorable for giving, with less restrictions on the use of appreciated securities. **Still, the concept of relating tax deductibility to the amount of appreciation of assets donated, along with donor choice of payout ratio, seems valid and eminently fair to all parties.**

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Respecfully submitted,

Louise J. Rosenberg Claude Rosenberg, Jr.

TESTIMONY OF JACKIE R. MCCLAIN
EXECUTIVE DIRECTOR OF HUMAN RESOURCES, AFFIRMATIVE ACTION, THE UNIVERSITY OF MICHIGAN

AT A HEARING OF THE SUBCOMMITTEE ON OVERSIGHT,
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

Thank you Mr. Chairman and members of the sub-committee for allowing me this opportuntiy to provide this statement for the record:

I have the privilege of serving as the Executive Director of Human Resources and Affirmative Action at the University of Michigan at which some 26,000 faculty and staff provide services to 47,900 students in 20 schools and colleges. In this capacity, I am acutely aware of the critical need for the enactment of legislation which would make the exclusion for employer provided education assistance (Section 127) a permanent part of the Internal Revenue code.

As you know, Section 127 permits employees to receive up to $5,250 annually in tuition reimbursement from their employers on a tax-free basis. One essential aspect of this provision is that it applies to both undergraduate and graduate education. Such assistance enhances job satisfaction and encourages continual upgrading of skills and knowledge. Such assistance may be the only realistic means of seeking such educational opportunities for many employees of the University of Michigan.

Since 1990, between 1200 and 2300 University of Michigan staff members have annually utilized our tuition reimbursement program. The program has cost approximately $500,000 annually but has greatly benefited not only the employees receiving the assistance, but the departments benefiting from their enhanced capabilities. Many employers such as the University of Michigan are willing to provide funding for employees to secure additional education, however, many of the employees who might take advantage of this benefit find the taxation on such benefits to be prohibitive. Therefore, extension of this exclusion is critical to their ability to capitolize on the assistance.

In support of the extension I would offer the following statements:

1. **The permanent extension of this exclusion would provide educational assistance benefits to many low and moderate income employees who seek to better themselves.**

Many of our employees have enrolled in area community colleges in order to seek continuing education while working full-time, often with family obligations as well. A 1989 Coopers and Lybrand survey indicates that 71% of the Section 127 beneficiaries earn under $30,000. This would seem consistent with the University of Michigan experience. This tax exclusion is especially important for women and minorities and those in lower paid positions who need improved skills to qualify for increasingly complex and technical jobs. These are often the individuals who have few resources to seek such educational opportunities on their own and for whom even the taxation of the benefit becomes burdensome.

2. **With rapid advances in technology, the need for retraining and re-education of employees to maintain a stable workforce is a critical employer issue.**

Employers throughout the United States are experiencing rapid changes and growth in the use of technology. With the advent of the daily use of computers and specialized computer programming, as well as telecommunications and internet communications, the employees of today requires a skill base which must change frequently to allow them to fully utilize technology in the effective performance of their job.

For such employers, movement toward the use of technology is both cost effective and pro-employee. We have adopted the practice, not of replacing employees who lack technical skills, but of providing employees with the opportunity to obtain such skills.

Employers benefit from a highly skilled, computer literate workforce through increased productivity and enhanced customer service. However, especially among our lower to mid-level employees - who have perhaps the most to gain from continuing education to obtain the necessary technological skills - educational opportunities may be simply out of reach when employer provided or subsidized training is taxable in nature.

3. **The lack of a permanent extension results in uncertainty for both employers and employees and presents numerous problems.**

At the exclusionary limit of $5,250 advanced under this legislation, employees could experience the added cost of approximately $1000 to $2000 in

their tax bill. Faced with the uncertainty of whether educational assistance accepted in the near term might vary in cost to this degree, many employees will likely choose to act conservatively and either eliminate or reduce the educational assistance they accept.

Further, the uncertainty and confusion surrounding the actual employee cost of employer provided educational assisstance undermines what I believe is widely considered a valuable employee benefit. As a Human Resources professional, and more particularly, as a Human Resources professional at an institution of higher learning, I believe this confusion sends employees precisely the wrong message about the importance and value of continuing education.

One only needs to look to the legislative history of Section 127 to understand the reason for current uncertainty. Since the Revenue Act of 1978, Congress has legislated five extensions of Section 127, but each time only temporarily. Repeatedly, the Section has lapsed, and then been reinstated retroactively. The permanent extension of this provision would achieve what has repeatedly been the will of congress, while reducing educational planning uncertainties for employees and administrative difficulties for employers.

STATEMENT
BY
CONGRESSMAN JOE MOAKLEY
ON H.R. 540, LEGISLATION TO RESTORE
SECTION 120 OF THE INTERNAL REVENUE CODE

Madam Chairperson and Members of the Subcommittee, thank you for holding this hearing on legislation to restore Section 120 of the Internal Revenue Code. I am a strong supporter of H.R. 540 and urge the Members of this subcommittee to report this measure favorably.

Section 120 of the Internal Revenue Code was first enacted in 1976 and it was so successful that Congress renewed it seven times. It encourages employers to pay for preventive legal services for employees and their families by excluding from their income the first $70 per year contributed to a qualified legal service plan.

Employer-financed group legal service plans have become a safety net for more than 2.5 million Americans. Members of the plan are able to gain access to affordable and qualified legal representation to settle disputes. In many instances, members are able to avoid personal disasters, like losing a family home, declaring bankruptcy due to insurmountable debt problems, or losing custody of a child.

In Massachusetts, section 120 has benefitted more than 120,000 members and their families. These people are not wealthy, they are hard working, tax paying, middle class Americans. They are teachers, policemen, firemen, waiters, government workers, electricians, carpenters and autoworkers.

Not only does Section 120 benefit employees but it is good for businesses. Because employees are able to contact lawyers upon learning of the problem, they are able to resolve them quickly and avoid costly litigation. Thus, employees are much more productive at work because they are not distracted by legal problems.

There is no organized opposition to group legal services plan. It enjoys the broad bi-partisan support of labor, consumer, bar, and insurance groups. These plans are a sensible approach to help people avoid costly, and disastrous legal problems.

I urge my colleagues to reinstate section 120 of the Internal Revenue Code. It benefits hard-working middle class Americans before it is to late.

STATEMENT OF MARY KELLER, VICE PRESIDENT

MORGAN GUARANTY TRUST COMPANY OF NEW YORK

Oversight Subcommittee

Committee on Ways & Means

United States House of Representatives

May 9, 1995

On behalf of the Morgan companies, including Morgan Guaranty Trust Company of New York, one of America's leading financial institutions, I congratulate and thank the Committee on Ways & Means for considering reinstatement of Section 127 of the Internal Revenue Code, the income exclusion for employer-provided educational assistance, and urge prompt approval of legislation that would restore Section 127. We also thank Congressmen Levin, Shaw, Camp, and Rangel -- and the many other members of this House who have worked to secure permanent reinstatement of Section 127.

This statement is submitted for the record of the Oversight Subcommittee's hearings concerning various expired provisions of the Internal Revenue Code, and we ask that a copy of this statement be made part of the record.

Morgan has long advocated a permanent extension of Section 127. In 1988, we testified before the Senate Finance Committee in support of legislation to restore Section 127 and make it a permanent part of the tax code -- and we have previously submitted statements in support of the program. During this time, Section 127 has survived on temporary extensions alone, some lasting only a matter of months. These temporary extensions were surely to be preferred to the alternative of letting the program die -- but they have worked a hardship on employees trying to plan for their education. We are hopeful, therefore, that these hearings will result in permanent reinstatement of Section 127 -- or, failing that, long-term extension of the program.

We believe in tuition assistance. Morgan provides hundreds of thousands of dollars in tuition assistance to its employees each year. We believe that the Morgan program is typical of the educational assistance programs offered by other major corporations and financial institutions. Our program is open to any full-time employee with at least six months service. We provide reimbursement for approved courses leading to undergraduate or graduate degrees and job-related certificates. Employees must receive a grade of "C" or better (or "Pass" in a "Pass/Fail" course) to qualify for reimbursement. Our employees have been enrolled in courses at private and public colleges and universities and have participated in special certificate programs at institutions like the American Institute of Banking, the educational affiliate of the American Bankers Association.

Our own experience supports the numerous studies that have found that Section 127 primarily benefitted low and moderate income employees. This year, much attention has

been given to the merits of a middle class tax cut. Without Section 127, middle class employees receiving educational assistance from their employers actually face the prospect of a tax *increase* -- an increase that they can only avoid by giving up tuition assistance. In short, employees will be penalized for pursuing their education. As we look for ways to encourage employees to pursue training opportunities, this simply makes no sense.

Some people are concerned by the alleged costs of this program. We believe that these concerns are misplaced. First, since Section 127 was part of the tax code for roughly 17 years, those who advocate its termination are looking for ways to raise money -- not save money -- by imposing a new tax on the middle class. Second, and more important, we believe -- and have always believed -- that Section 127 pays for itself.

A few simple illustrations -- based on our own experience -- should make this clear. At Morgan, a secretary who obtained her undergraduate degree through the tuition program subsequently became an assistant vice-president of the bank, making twice the salary she would have made in her secretarial position. A messenger who joined the program after joining the office staff was appointed an officer soon after obtaining his degree, earning nearly twice the salary he would have earned in a normal clerical career path. A former mail clerk who worked his way through the ranks and obtained an undergraduate degree in business administration later earned in excess of $100,000 as a vice-president of the bank.

These are admittedly dramatic success stories -- but they are real. In 1992 we reviewed a random sampling of employees who participated in the Morgan tuition assistance program in 1987. We found that -- between 1987 and 1991 -- salaries for several of the employees had increased by more than 40% -- with some increases ranging as high as 106%. These salary increases are well in excess of adjustments accounted for by inflation or customary step-increases. Although we have not conducted a current survey, we know of numerous employees who were hired in clerical or administrative positions, participated in the tuition assistance program, and now hold professional positions. Some are officers of the bank.

It should be self-evident that these employees have paid and continue to pay taxes well in excess of the tax revenues foregone by allowing them to receive their tuition payments tax-free. Reviewing the individual tax liability of a typical employee who obtained a college degree through a tuition assistance program, we believe that -- over a five year period -- the Federal government would realize a 900% gross return on its initial tax "investment."*

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* In 1988 we reviewed the hypothetical example of a clerical employee earning between $20,000 and $24,000 during five years in which she pursued an undergraduate diploma with assistance from the bank. We assumed that the employee obtained an undergraduate degree, and -- five years later -- earned $55,000. Assuming no dependents or other income, and taking only the standard deduction, we calculated that this employee would have paid about $13,500 in taxes in 1987 alone -- almost $9,000 more than the taxes she would have paid if she had remained in a clerical track and were earning $29,000. Assuming further that this employee had received $1,800 in tuition assistance in each of the years that she was in college, the total tax foregone while she was in school would have amounted to $3,090 -- only one-third of the total increased tax which the employee later paid in a single year. Using reasonable assumptions, we calculated that -- over the five year period following her education -- the Federal government realized a 900% return on its initial tax investment, a total of $28,000 in additional taxes. Even factoring in a reasonable interest rate on the foregone revenues, the return on investment would have exceeded

Admittedly, this conclusion is based on a rough cut analysis. Nevertheless, we believe it is fair to assume that -- for most workers -- the increased training made possible by Section 127 translates into higher income -- and higher taxes. Without Section 127, it is fair to assume that many employees will abandon or cut back on their educational plans. To the extent that workers abandon their education the government will not realize any increased tax revenues whatsoever.

Of course, the purpose of providing educational assistance is not to generate tax revenues. The purpose of educational assistance is to enhance the skills of the workforce. An educated workforce is a more productive workforce. Increased productivity makes American businesses more competitive worldwide. And, while increased revenues to American business also mean more tax revenues for the government, they also provide new jobs and strengthen the American economy. Without Section 127, the opportunity to enhance the competitive skills of the workforce through tuition assistance programs may be lost or, at best, delayed.

Another compelling reason to retain Section 127 is the role that it plays in helping minorities and women who want to continue their education but cannot afford to do so on their own. Morgan is deeply committed to equal employment opportunity -- and our tuition refund program is an integral part of our efforts to attract and keep minorities and women. Our program is open to anyone who meets the program's criteria and is willing to do the work. Women have historically accounted for nearly 80% of the employees participating in our program -- and better than 50% of the participants have been members of racial and ethnic minority groups. These employees, by their participation in the tuition assistance program, have demonstrated the will to succeed despite financial obstacles. For them, employer-provided educational assistance is not a "fringe" benefit or a "frill." It is, instead, critical to their continued pursuit of their educational objectives. These employees are going to school at night and on weekends. They work hard at their education. They deserve our support.

Without any government bureaucracy, and with minimal paperwork, Section 127 has helped hundreds of our employees to obtain college and graduate diplomas. In 1994, our employees were enrolled in undergraduate programs in 49 colleges and universities in New York and New Jersey, ranging from small community colleges to nationally recognized universities like Fordham, Hofstra, and Rutgers. (A list of these schools is attached.) It is one of the true success stories in the tax code -- and it pays for itself many times over its costs. When the Senate Finance Committee approved Section 127 in 1978, the Committee observed that the then-current practice of taxing tuition payments worked as a "disincentive to upward mobility." That concern is no less valid today. Simply stated, there is no good reason to tax employees for pursuing their education -- and many good reasons not to. If this nation is to maintain a workforce capable of competing in an increasingly competitive world economy, we must retain Section 127.

We thank you for this opportunity to express our views.

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*(...continued)
500%. Of course, the increased tax revenues would be likely to continue year to year over the taxpayer's lifetime.

UNDERGRADUATE COLLEGES AND UNIVERSITIES
ATTENDED BY MORGAN EMPLOYEES PARTICIPATING IN THE
TUITION REIMBURSEMENT PROGRAM
1994

American Institute of Banking
Audrey Cohen College
Baruch College
Berkeley School
Bloomfield College
Borough of Manhattan Community College
Brookdale Community College
Brooklyn College
City College
College of New Rochelle
College of Staten Island
Dominican College
Fashion Institute of Technology
Fordham University
Georgian Court College
Heald Business College
Hofstra University
Hudson County Community College
Hunter College
Iona College
Jersey City State College
John Jay College of Criminal Justice
Kean College
Kingsborough Community College
LaGuardia Community College
Lehman College
Marymount College
Marymount Manhattan College
Medgar Evers College
Molloy College
Montclair State College
Nassau Community College
New York University
NY Institute of Technology
NYC Technical College
NYU School of Continuing Education
Ocean County College
Pace University
Queens College
Rutgers University
School of Visual Arts
St. Francis' College
St. John's College
St. Peter's College
SUNY Farmingdale
Westchester Community College
William Paterson College
York College

STATEMENT OF GERALD MANN, ADMINISTRATOR AND CHIEF COUNSEL, DISTRICT COUNCIL 37, MUNICIPAL EMPLOYEES LEGAL SERVICES PLAN

Mr. Chairman and Members of the Committee, my name is Gerald Mann and I am submitting this statement as Administrator of the District Council 37 Municipal Employees Legal Services Plan, a prepaid legal services plan for the approximately 130,000 employees of New York City and related agencies who are represented in collective bargaining by District Council 37 of the American Federation of State, County and Municipal Employees, AFL-CIO. I am also here today on behalf of the National Resources Center for Consumers of Legal Services, the American Prepaid Legal Services Institute, and others.

My comments concern Section 120 of the Internal Revenue Code which expired on June 30, 1992 and which is the subject of H.R. 540, introduced by Representative Rangel, now pending before your committee. Section 120 determines the tax treatment of qualified group legal service plans. It provides that contributions made by an employer to and the value of any legal services received by the employee under such a plan can be excluded from the employee's taxable income.

Section 120 has been extended by Congress seven times in 1981, 1984, 1986, 1988, 1989, 1990, and 1991. H.R. 540 proposes that Section 120 be made a permanent provision of the tax code.

The record of seven Congressional extensions following intensive legislative review, suggests that Section 120 has stood the test of time as good public policy. Our discussion over the years with members of Congress indicate that there is virtually no substantive opposition to the idea of encouraging employers to provide legal services benefits in the same manner as they provide health care and other benefit programs designed to assist employees and their families.

There is no question about the need for making basic personal legal services available to moderate income families at reasonable cost. Clearly, the average family cannot afford the high cost of personal legal services. This problem has been documented in the American Bar Associations landmark study of the legal needs of the low and moderate income public. These figures tell us that about 50 percent of us will encounter a problem in the next twelve months which a lawyer could help resolve, yet only 21 percent of low income households will actually obtain legal services.

The growth of prepaid legal services and the recognition of its value by both labor unions and employers indicate that it is the innovative legal services delivery system which could surmount current income barriers and provide access to justice for the moderate income American.

The rationale for legal services as a benefit for employees is much the same as that for medical and other insurance benefits: to assure the personal well-being of employees and their families so that they can continue to be permanent and productive members of the work force. Legal plans offer employees preventive legal care -- preventing a minor problem from becoming a major legal entanglement through early treatment.

For some -- too poor to afford private legal assistance, yet employed and earning just enough to make them ineligible for government-financed legal aid -- lack of access to legal services is not just an inconvenience. It can be a matter of survival. For many low and moderate income working Americans, current economic conditions have increased their need for legal help in regard to potentially devastating personal problems such as child support enforcement, housing, evictions, consumer debt, divorce and custody, and child abuse.

At the legal services plan office in New York, we often see clients with multiple problems. A serious unresolved legal problem tends to create a domino effect on the life of a moderate income family. A debt problem can lead to a garnished salary, eviction, disintegration of the family unit, and in some cases, even loss of a job, dependency on public assistance and homelessness. The relatively small cost of the legal services plan is repaid many times by keeping the family intact and self-sufficient.

Of the approximately 10,000 new cases our office handles each year, almost 3,000 involve consumer problems and debt, 2,000 cases involve a landlord seeking to evict our workers and 3,000 matters involve family problems, such as enforcement of child support, divorce, adoptions, family violence and abuse and neglect of children.

Today's economic uncertainties and the realistic fear of loss of a job has had a devastating effect on family relationships. Incidents of family violence have increased as has child abuse and neglect.

Working grandparents have had to assume the burden of raising and supporting young children because a generation of parents have been incapacitated by drug and alcohol abuse. In all of this, a lawyer's intervention is necessary to assist in maintaining what remains of the family structure.

We represented a 43-year-old woman who works for New York City's Department of Social Services as a computer operator. Her husband, who began to physically abuse our client had left the home. Our client is now the sole support of two children, ages 7 and 12. Family emergencies had caused her to fall behind in rent payment and she now faces eviction proceedings.

She worried constantly about the effect of neighborhood drug traffic and violence upon her children. During one office visit, she began crying and was unable to stop. She threatened suicide, and had to be taken to a hospital's psychiatric department by the emergency medical service. The legal service we provided enabled her to avoid eviction, file for divorce, obtain child support and be placed in an outpatient counselling program.

I am able to report the she remains gainfully employed and is now capable of maintaining her family unit.

These New York City public employees, all working people of modest means, would not have been able to afford legal services from the private bar. The consequences of their not having access to a lawyer would have been severe.

Employer-paid group legal benefits plans make legal representation available to participants at a fraction of what medical and other benefit plans cost. By placing legal services on the same tax footing as other more expensive statutory benefits, Section 120 has encouraged employers to look to group legal benefits plans as an inexpensive way to enhance real employee compensation.

When our low income members and fixed income retirees received their 1994 W-2 forms requiring payment of income tax on the cost of their legal services coverage, they were outraged. To many of our members, the additional tax burden is a real economic hardship. It is difficult for them to understand why Congress has elected to single out this needed protection for inequitable treatment.

Legal plans have become an important consideration in employers' desires to provide fringe benefits which contribute to employee well-being while keeping costs under control. While the cost of health insurance benefits have tripled over the last 165 years, the cost of the legal service benefit plan I am familiar with have risen less than 40 percent over the last 15 years, or about 2.6 percent per year.

We urge Congress to finally resolve the issue of permanence for Section 120 and the other tax provisions expiring this year. The lack of an exemption has inhibited the adoption of legal plans by employers because of unpredictable tax consequences.

The time has come to make Section 120 permanent. Qualified group legal plans, which millions of working Americans depend on for basic legal advice, will be in serious jeopardy if Congress fails to renew Section 120. The provision's demise has already caused the termination of a number of legal benefits plans.

On the other hand, the cost of the Treasury of a permanent Section 120 is minuscule, if any. In today's world of scarce pre-tax benefit dollars, employers, instead may shift the amount of the contribution to other forms of tax-free statutory benefits.

What then would be the real results of the provision's permanent demise:

- The elimination of a valuable employee benefit for a major portion of the 2.75 million employees, plus members of their families, who are now covered;
- The loss of tax dollars that can be saved by reductions in the use of our courts to resolve minor disputes as a result of preventive legal services available to employees through qualified group legal service plans; and
- Decreased productivity in the workplace due to an increase in employee personal and legal problems.

In these difficult economic times, many middle class working Americans express little confidence that our political and legal institutions represent their interests. Working people will view a Congressional decision to abandon their employer-provided legal benefits as yet another example of a hit on the middle class. Further, the contention that our legal system exists only for the wealthy will be reinforced.

We now ask that Congress acknowledge its wisdom in having created Section 120 and having sustained its existence for 16 years by passing legislation which would make this provision a permanent part of our tax laws. H.R. 540 would accomplish this goal and we urge its adoption.

NATIONAL ASSOCIATION OF COLLEGE AND UNIVERSITY BUSINESS OFFICERS

Written Testimony of
Mr. Ralph H. Beaudoin
Vice President for Finance and Treasurer
The Catholic University of America
for the Record of the Hearing on

Section 127 of the Internal Revenue Code

Subcommittee on Oversight
of the Committee on Ways and Means
U.S. House of Representatives
Tuesday, May 9, 1995

The following associations join NACUBO in this statement:

American Association of Community Colleges
American Association of State Colleges and Universities
American Association of University Professors
American Council on Education
Association of American Medical Colleges
Association of American Universities
Association of Community College Trustees
College and University Personnel Association
Council of Graduate Schools
National Association for Equal Opportunity in Higher Education
National Association of Graduate-Professional Students, Inc.
National Association of Independent Colleges and Universities
National Association of State Universities and Land-Grant Colleges
National Association of Student Financial Aid Administrators
National University Continuing Education Association
United Negro College Fund

NATIONAL ASSOCIATION OF COLLEGE AND UNIVERSITY BUSINESS OFFICERS

Written Testimony of

Mr. Ralph H. Beaudoin
Vice President for Finance and Treasurer
The Catholic University of America

I commend the Subcommittee on Oversight of the Committee on Ways and Means for holding timely hearings to examine issues related to recently expired tax provisions and look forward to exploring with you in detail the importance of tax provisions that strengthen our work force and the nation's competitiveness in the world economy.

On behalf of the National Association of College and University Business Officers (NACUBO), I would like to express support for H.R. 127, legislation that would permanently reinstate Section 127–*Employer-Provided Educational Assistance* of the Internal Revenue Code which expired December 31, 1994. NACUBO is a membership organization representing chief financial officers, as well as business managers and administrators, at more than 2,100 of the nation's colleges and universities. The association is dedicated to promoting sound fiscal and administrative management of higher education institutions. The higher education associations listed above join NACUBO in this statement.

Since its enactment in 1978, Section 127 has provided needed and important tax relief to the many thousands of workers who have benefited from receiving educational assistance from their employers. It is in the nation's best interest to reinstate this provision of the tax law and make it permanent. A continuation of this form of tax relief is important for the following reasons:

- Section 127 makes education affordable for members of the work force who might otherwise be unable to attain additional training or higher education.

- Section 127 allows workers at all levels, but most importantly, at low-and-moderate income levels, to receive education to enhance their skills, retrain to prepare for new or modified jobs based on technological change, and prepare for new occupations.

- Section 127 encourages employees to attain advanced skills and education.

- Section 127 encourages employers in all sectors–public and private, profit and nonprofit–to provide educational assistance to their employees and promote the acquisition of new and higher skills in the work force.

Section 127 encourages employers to provide educational and training programs to their employees. In particular, low-wage and low-skilled employees have been supported in their efforts to seek specialized education necessary for job advancement, and employers have been encouraged to promote training and increase the technological sophistication of their work forces.

Section 127 has played a major role in providing opportunity, support, and access to millions of working Americans in obtaining education and training that is vital to the economic competitiveness of our country. Now, more than ever before, this provision is an important component of a national commitment to work force training. Section 127 is one very important way to provide encouragement for working Americans who seek to improve their skills. The provision also exemplifies good public policy by helping the individual and also contributing to upgrading the nation's work force and maintaining our competitiveness.

Today, the world's economy depends upon communications and information as competitive tools. The race to obtain information drives the technologies necessary to produce it. Knowledge grows and new opportunities present themselves. This rapidly increasing pace of technological advancement on a world-wide basis requires that America's

work force have access to new knowledge through continuing training and education. Only then can we take full advantage of the opportunities.

Rapid technological change also presents new ethical issues for our society. Medical breakthroughs in genetic engineering, transplants, life sustaining machines, and *in vitro* fertilization are but a few of the areas of ethical concern. More education in the liberal arts and in particular, ethics will be necessary for our society to face the social and ethical questions that technological breakthroughs are posing and will continue to pose.

Continual changes in our nation's economy and world markets lead to the displacement of American workers. We can expect to be displaced *at least twice* (and many futurists indicate many Americans will change their careers as many as seven or eight times) during our work life. We can no longer count on permanent employment with a single employer. Even corporations best known for long-term commitments to their employees such as IBM and AT&T have had to abandon these long-standing traditions. Americans need the opportunity to improve and update their knowledge in order to maintain their contributions to our society and our economic way of life.

It is not surprising that adult students returning to school to obtain undergraduate and graduate education represent the largest growing sector of the nation's student body. Global competitiveness is very much felt at the personal level and Americans are responding in record numbers by increasing their knowledge and skills through education. As a society, we need to encourage their effort by providing access and encouragement through measures like Section 127.

As we approach the 21st century, more of the "hired hands" will be replaced by the "hired minds." American brain power will be necessary to maintain the country's competitive position and safeguard its way of life. The developed intellect is the vital capital needed to solve the problems we face now and will meet in the future. Section 127 is one way to contribute to the formation of our country's intellectual capital.

On behalf of NACUBO and the other organizations that join in this testimony, we urge you to support H.R. 127, a bill that will make this important provision a permanent part of the Internal Revenue Code.

We are grateful to the Committee for this opportunity to express our interest and concern.

Statement of
Sanford T. Rosenthal, EA
National Association of Enrolled Agents

Oversight Subcommittee
Committee on Ways and Means
U.S. House of Representatives

On behalf of the National Association of Enrolled Agents, I wish to submit this statement for the record.

NAEA appreciates the opportunity to present this statement on behalf of its approximately 9,000 Enrolled Agent members and to speak for the individual and business taxpayers whom we represent. Enrolled Agents are professional individuals whose primary expertise is in the field of taxation and taxpayer representation. As the Sub-Committee members well know, the Enrolled Agent profession was created by an Act of Congress in 1884 to provide for competent and ethical representation of claimants before the Treasury. We are proud to say we have been diligently fulfilling our responsibilities for the past 111 years.

Enrolled Agents establish their expertise in taxation and taxpayer representation by either passing the Internal Revenue Service's comprehensive two-day examination on federal taxation or by serving as an IRS employee in an appropriate job classification for at least five years. NAEA Members maintain their expertise by completing at least 30 hours of continuing professional education each year. Our Members work with more than four million (4,000,000) individual and business taxpayers annually.

It is in our role as the voice for our Members and for the general taxpaying public that NAEA submits this statement for the record on certain expired and expiring tax provisions.

I would like first to thank the Ways and Means Committee for its prompt action in extending and making permanent the deduction for medical insurance premiums for the self-employed. This is critically important for the many small businesses with which Enrolled Agents typically work. While I understand that revenue constraints limited the amount deductible to 25% in 1994 and 30% for the following years, I would ask that you consider revisiting this issue again. This is a priority for all small business owners, and for reasons of fairness and equity with other forms of businesses, the amount deductible by the sole proprietors should eventually be increased to one hundred percent (100%).

Benefit to Small Business and the Nation's Economy by Permanent Extension of Expired and Expiring Tax Provisions

These provisions include the targeted jobs tax credit, the exclusion for employee educational assistance, and the tax credit for research and experimentation. Each of these provisions offers employers and employees the ability to "bootstrap" to higher levels of productivity, with subsequent increased income, and eventual permanent increases in income tax revenue resulting from the higher incomes.

Targeted Jobs Tax Credit

This tax credit provides incentives to employers to hire individuals who might otherwise have a difficult time finding employment. The benefit to the employee is eventual self-sufficiency and self-esteem. Society benefits by the employment of marginalized workers who, by being brought into the workforce, can support themselves and their families.

The targeted groups might be periodically modified as social and economic changes warrant. For example, in times of high unemployment, those who have been unemployed for more than one year should be included as a targeted group. Maimonides said hundreds of years ago that "it's better to teach a man to fish than to give him fish". It's a better use of scarce resources to

provide incentives to employers to reach those who are out of the work force. Reinstatement and extension of the targeted jobs tax credit is particularly timely in light of calls for replacement of welfare with work. In view of the benefit to individuals, families and society, it is recommended that the targeted jobs tax credit be reinstated and made a permanent part of the tax code.

Employee Educational Assistance

Employee educational assistance enables workers to obtain non-job related education which will increase their productivity, and benefit both themselves and their employers. It is of particular importance to lower-income workers and to those who are just starting out and who find they need additional education, if they are to move ahead.

According to the well-known Coopers & Lybrand study, "Who Benefits? At What Cost?", the distribution of benefits closely matches earnings among the labor force as a whole. Seventy-one percent (71%) of Section 127 recipients earn less than $30,000 per year and more than one-third (36%) earn less than $20,000 per year. The majority of those using Section 127 benefits are taking business-related courses, followed by courses in engineering, health science/nursing, education and computer science. Less than one-half of one percent are attending professional schools.

The repeated expiration and reinstatement of Section 127 has been very damaging and discouraging to those using employee educational assistance to improve their work skills. Employees are forced to choose between rolling the dice on Congressional reinstatement of this exclusion or having to pay taxes on tuition reimbursement. Many, because of their relatively low incomes, simply drop out of school.

The improvement of the skills of our nation's workforce should be encouraged in every way possible. Employers need to motivate employees to upgrade their skills just as the G.I. Bill motivated our war veterans in years gone by. We believe that this is a cost-effective mechanism, a partnership between employers, employees and the federal government which works very well. Therefore, it is recommended that Section 127 be reinstated and made a permanent part of the tax code.

Tax Credit for Increasing Research Activities

As a California resident, I can attest to the beneficial effect of increased research activities in my state. Many of today's high tech companies started out as small businesses, in some cases they literally began in someone's garage. Research has benefited employers who develop new, improved products that result in more income and profit. Employees benefit by the availability of new jobs. As a nation, we all benefit from maintaining our ability to compete in the global marketplace. This provision also substantially enhances several major tax bills under consideration by Congress.

The R&E tax credit, as the other provisions mentioned before, has suffered from periodic lapses and subsequent reinstatement. It needs to be extended before the June 30 expiration date and made a permanent part of the tax code.

Conclusion

The National Association of Enrolled Agents thanks the Sub-Committee for the opportunity to comment on these provisions. Congresswoman Johnson's efforts in furthering the improvement of the Internal Revenue Code are appreciated by our Members, both as tax professionals and as taxpayers. We stand ready to assist you in this endeavor.

NCSSSA *National Conference of State Social Security Administrators*

May 4, 1995

Phillip D. Mosely, Chief of Staff
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Mosely:

This is in response to the call for written statements for the hearing on several recently expired provisions of the tax laws to be held May 9, 1995 by the Subcommittee on Oversight of the Committee on Ways and Means. The National Conference of State Social Security Administrators wishes to address the exclusion for employer-provided educational assistance.

Let me first provide some background on our organization. The NCSSSA was formed more than 40 years ago and represents more than 70,000 state and local governmental employers across the nation. We have enjoyed an excellent working relationship with the members of both chambers of Congress and their staffs during this time. The NCSSSA also has developed direct lines of communication with the Social Security Administration and the Internal Revenue Service that are used to address the myriad of employment tax and coverage issues governmental officials must face each day.

It is this wide range of coverage and reporting issues that brings us to address the exclusion for employer-provided educational assistance. The rules, regulations and procedures of federal employment taxes, as well as, social security and medicare coverage appear to change almost daily. Today's rapidly evolving technology that is required to withhold, deposit and report employment taxes and to maintain proper social security and medicare coverage on the nation's state and local governmental employees didn't even exist until recent years.

While this speaks only of those state officials involved in employment taxes and social security/medicare coverage, it could well speak for any employer in America. The demand for highly motivated and well educated employees is greater than ever. It is a constant struggle to keep up with the requirements of the workplace and continuing education for employees is a must for any successful enterprise, public or private.

There is a cost to maintain an efficient and well run organization and that cost erodes the profits of private firms and uses much needed tax dollars for public agencies. The provision excluding employer-provided educational assistance is a simple, cost-efficient tool that benefits both the employee and the employer. One should remember the adage, "Knowledge is the only instrument of production that is not subject to diminishing returns."

A well educated, knowledgable work force is vital not only for businesses and public organizations, but for America as a whole. Each individual's life should be a continuing education. Congress has an obligation to encourage, even lead, the nation's work force to better training and higher levels of skill. That is why the NCSSSA believes that, for the good of the nation, the exclusion for employer-provided education assistance should be reinstated.

If you have any questions, please contact me at (502)564-3952 or PO Box 557, Frankfort, Ky 40602-0557.

Sincerely,

Patrick L. Doyle

Patrick L. Doyle, Chair-Person
NCSSSA Legislative Committee

Statement of
William A. Bolger
on behalf of the
National Resource Center for Consumers of Legal Services

The National Resource Center for Consumers of Legal Services strongly supports H.R. 540, which would reinstate the exclusion from employees' taxable income for the first $70 contributed by their employers to qualified group legal services plans under Section 120 of the Internal Revenue Code.

The National Resource Center is a non-profit research and education organization working to improve the legal system. Since our founding in 1972 our primary focus has been on legal services plans because of their potential for encouraging preventive law for the average American.

1. Legal Services Plans Have Proven Their Value.

Plans help families. Legal services plans provide the average American with same access to preventive legal services that wealthy individuals and large businesses have always had. They enable people to avoid legal difficulties and more quickly solve problems that do arise, thus unburdening the court system and keeping employees on the job, undistracted by legal problems. Legal services plans:

>promote family harmony by preventing or resolving serious legal problems

>increase the level of justice by making legal advice more available to the average citizen

>improve economic productivity by keeping employees on the job and focused on their work

>help both the public and private portions of the legal system function more efficiently

Why plans work. Legal services benefit everyone because transaction costs are reduced when advance arrangements are made on a group basis for providing needed legal services. Advance payment is not as important as advance arrangements that make legal services readily available. These advance arrangements dramatically reduce the time, cost and uncertainty involved in selecting and consulting a lawyer when a legal question arises. People covered by a plan contact a lawyer more often, but at an earlier point in the course of a problem. More people receive legal advice, about more matters, but matters are handled at lower cost and in a way that minimizes disputes and litigation.

Legal services plans exhibit considerable diversity in structure, cost and benefits depending on the group of people covered--their number, geographic distribution, family situation, etc.--and the funding available. The plans are privately administered. The lawyers who provide services to plan members are mostly in private practice, and all are subject to state rules of practice. The plans themselves are regulated through ERISA like other employee benefit plans.

Congress was right. In enacting section 120 in 1976 Congress meant to encourage more equal access to legal help for middle income Americans. You succeeded. The Treasury's own June 1988 study of legal services plans found that "plans covered by section 120 did provide relatively greater access to legal services to production workers and union members" (than to professional and administrative employees). "(T) his pattern stands in **stark contrast** to most other kinds of employee benefits, which are relatively less available to production employees." (emphasis added)

Section 120 puts legal services plans on a more equal footing with other statutory fringe benefits. Even the most comprehensive plans seldom cost more than $150 per family per year.

Section 120 was originally enacted as a five-year experiment. Policy makers were concerned about whether the benefit would wind up accruing only to highly-paid executives, whether employer contributions would be insufficient to finance the arrangement and whether inflationary pressures would escalate the cost of legal service plans, as has happened in the case of medical care.

But in considering section 120's fate in 1981, Congress agreed that none of these evils manifested themselves during the five-year trial period. In fact, legal service plans were shown to benefit low and moderate income workers on a non-discriminatory basis. The modest funding formula used to finance these plans not only was shown to provide more than adequate financial support, but costs barely increased during the period. In light of this record, Congress extended the provision for three more years, then extended it five more times for shorter periods.

Even in the face of expirations and retroactive reenactments, section 120 served its purpose. There are now approximately 3.1 million employees and retirees covered by qualified group legal service plans at an average cost of under $100 per worker per year. Since these plans also provide access to essential legal services for family members, a total of 7.6 million Americans now benefit from employer-provided legal services.

Employer-paid legal services plans have so clearly proven their value that almost no one opposes them. Everyone agrees they are a good idea and that they work. The only excuse for letting section 120 expire was that the government needed the $85 million per year attributed to section 120.

2. Letting Section 120 Expire Was An Unfair Tax Increase On The Middle Class.

All employees covered by an employer-paid group legal services plan suffered a tax increase when section 120 expired. So did contributing employers, who now have to pay Social Security payroll taxes on their contributions. Reinstating section 120 would rescind that tax increase.

Almost as important to employers as the payroll taxes they have to pay is the administrative burden of accounting for the contribution. Consider, for instance, plans covering retired workers. Retired employees now incur a tax liability for contributions made on their behalf by their former employers, who are required to issue W-2 or 1099 forms for them.

So far, few existing plans have been terminated because section 120 expired, but as plans come up for renegotiation in a period of tough global competition, health care cost pressures and static wages, the taxability of legal services plan contributions can only work against them compared to tax-favored benefits.

Section 120's expiration has also deterred additional employers from beginning to offer group legal service benefits, given that other non-taxable benefits are readily available. Where taxable group legal service benefits are offered in a flexible benefit plan, they have been in some instances slighted in favor of other non-taxable benefit options.

State income tax ramifications are also important. Many states' personal income tax laws follow federal income tax exclusions. Since section 120 expired, employees in those states effectively have seen an increase in their state income taxes.

Tax revenue insignificant. While the current taxability of plan contributions threatens their future, it is producing insignificant tax revenue to the federal government. The Joint Committee on Taxation's latest estimate was that letting Section 120 expire would produce $85 million in revenue, an infinitesimal percentage of the federal budget. Even that estimate is too high, because it ignores shifts in contributions that are already occurring from legal services plans to health benefits and others that remain tax-exempt.

Congress should rescind the back door increase on middle class Americans resulting from the expiration of Section 120 and reinstate the Congressional policy of encouraging private efforts to achieve justice more efficiently for the average citizen.

3. Legal Services Plans Enjoy Broad Support.

Legal services plans are supported by consumer groups, business, the bar and the labor movement. There is no longer any opposition to them. The few early skeptics have been proven wrong. Bar groups that felt threatened now recognize that plans enable more people to afford timely legal assistance.

A bill identical to H.R. 540 was cosponsored by 220 members of both parties, including both Speaker Gingrich and Subcommittee Chair Nancy Johnson. Legal services plans are not controversial and Section 120 is not costly.

Please restore equal tax treatment for legal services plans by enacting H.R. 540. There is no simpler, cheaper or easier way to make the legal system work better.

Statement
of the
National Society of Professional Engineers
on the
Tax Exclusion of Employer-Provided Educational Assistance

May 24, 1995

The National Society of Professional Engineers supports legislation (H.R. 127) to make permanent the tax exclusion for employer-provided educational assistance (Section 127 of the Internal Revenue Code).

The National Society of Professional Engineers (NSPE) was founded in 1934 and represents over 65,000 engineers in over 500 local chapters and 52 state and territorial societies. NSPE is a broad-based disciplinary society representing all technical disciplines and all areas of engineering practice, including government, industry, education, private practice, and construction.

Section 127 of the Internal Revenue Code allows individuals to exclude from their gross income the value of educational assistance provided by an employer through an employee educational assistance program. The provision is a key plank in our nation's workforce preparation program, benefitting employees of all educational and experience levels. Section 127 plays an important role in assisting engineers in their career-long education. Formal courses are an essential component of an engineer's continuing professional development, particularly given the rapid pace of technological change.

Furthermore, as the nation's industrial and manufacturing base shifts in response to global military and economic changes, there is a need to provide engineers and other highly-skilled worker opportunities to shift with those trends. Most often, these shifts require the acquisition of new knowledge and skills. Tax incentives that encourage employers to incorporate tuition assistance into their continuing education programs are an appropriate response to these challenges facing the engineering profession.

The Section 127 tax incentive provides a mechanism for the government to encourage private sector development of a strong workforce base on which to build future economic stability. Also, the tax incentive relies on existing education and training resources already available, rather than establishing costly, new programs.

NSPE seeks permanent enactment of Section 127 because short-term extensions prevent beneficiaries from making long-range education plans with confidence. In fact, some eligible participants may choose not to avail themselves of the benefit as a result of the uncertainties involved with temporary extension.

Section 127 is a sensible use of tax policy to enhance the preparation of our nation's workforce. It has our full support.

PRE-PAID LEGAL SERVICES, INC.

Representative Nancy L. Johnson
Subcommittee of Oversight, Committee on Ways and Means
U.S. House of Representatives
Washington DC 20515

Dear Representative Johnson:

I am writing to urge your support of H.R. 540 not only because this legislation is personally good for Pre-Paid Legal Services, Inc., a major employer in southern Oklahoma and the only pre-paid legal services company that is publicly held. It is also good for workers in America, more of whom will be able to receive this product as a benefit. Our comprehensive plan of legal benefits for the whole family should be on equal footing with health insurance as a tax deductible expense. Studies have shown that this type of product contributes to employee well-being and productivity. Favorable tax treatment of this benefit certainly needs to be reinstated.

Please add your valuable support to H.R. 540. Let's provide a great value to our work force through this benefit. Working Americans certainly need low-cost legal advice. Group legal service plans should be on equal footing with other statutory fringe benefits.

We appreciate your help and we thank you for the tireless efforts you give for our great country.

Cordially,

Harland C. Stonecipher

Harland C. Stonecipher
Chairman
Chief Executive Officer

STATEMENT
OF
THE HONORABLE CHARLES B. RANGEL
ON THE TARGETED JOBS TAX CREDIT AND EMPLOYER PROVIDED GROUP LEGAL SERVICES
BEFORE THE SUBCOMMITTEE ON OVERSIGHT OF THE COMMITTEE ON WAYS AND MEANS

MAY 9, 1995

Madame Chair I am sorry that I was unable to appear before the Subcommittee in person and so I am submitting this testimony for the record.

I want to indicate my strongest support for the extension of the Targeted Jobs Tax Credit program and the renewal of the exemption from taxation of the value of employer provided group legal services. Both of these programs are important to those in our communities who are less fortunate. One enables many to enter the work force for the first time. The other helps the working person to feel secure in an ever complex society.

TARGETED JOBS TAX CREDIT

I want to join my colleague from New York, Congressman Amo Houghton, in introducing the revised extension of the Targeted Jobs Tax Credit. The changes we are proposing are as a result of the hearings held last Congress where the Committee heard extensive testimony from Secretary of Labor Robert Reich on how the credit needed to be better targeted and designed. It is also a reaction to a compelling need to help people move out of welfare.

One of my biggest concerns about the welfare reform bill that the House has passed is the assumption that so many on welfare and so many fathers of children on welfare are just going to pick themselves up and find a job. Ah, if it was so easy we would not have a welfare problem. We know that most of the people on welfare want to work, but have neither training nor opportunities to secure work. In my district 14 applicants show up for each fast food job opening. Why does the manager have to hire a welfare mother or unemployed youngster when the manager can take on someone older with work experience? We need job training and incentives for employers to encourage them to hire these targeted people.

I have supported the Targeted Jobs Tax Credit since its inception back in 1978. In the last several years it was responsible for helping over 450,000 people per year enter the work force. Many of these people have been on welfare, from families on welfare, or would otherwise be on welfare. Many of those hired have begun successful working careers getting the basic skills necessary to stay in the working world.

In New York City the welfare agencies have turned to America Works, a private organization, to help ready and place welfare mothers in the work force. One of America Works' important tools is the Targeted Jobs Tax Credit. The funds from the credit help influence employers to take on the welfare mother as well as provide some of the operating costs of the America Works training and placement program.

I commend the Targeted Jobs Tax Credit community for working with Congressman Houghton, myself and the Department of Labor to revise the credit to answer many of the issues raised by the Labor's Inspector General and Secretary Reich. The emphasis will now be towards identifying those eligible up front before employment so that we will know that employers are truly targeting instead of just gleaning. The targeting will be directed more closely to those on assistance so that the program's cost will be offset by decreases in various forms of welfare spending. The financial incentives will be focused on retention of employees by increasing the benefit as tenure is extended.

We need to give hope to a generation of families on welfare. The hope of a better future worth working towards. Without it we are compelled to see future generations in the same predicament. Without that hope we are compelled to see more young people in prison and more out of wedlock children. We need to provide incentives to employers to create that hope with a job and a future. The Targeted Jobs Tax Credit is one of the incentives that can help employers do just that.

I am certain that we can create bi-partisan support for the Targeted Jobs Tax Credit. I hope that the Committee will make the extension of the program a very high priority.

I want to thank Chairman Archer and Chairwoman Johnson for allowing the issue of employer provided group legal services to be heard at this hearing. I recognize that in 1993 the exemption of this benefit was not renewed while others were. However, it is still very clear to me that it is important enough to raise again at this hearing on expired provisions.

I have introduced H.R. 540 to extend the exemption from January 1, of this year. Already, this bill has 34 co-sponsors without even a "Dear Colleague" being circulated. I am sure that this bill will be supported by a large bi-patisan proportion of the House.

More than 2.5 million Americans were covered by employer provided legal service benefits. Without the tax exclusion, many employers have considered dropping this benefit and millions of Americans will lose their safety net when they face legal problems. Where programs continue working people are subject to an increase in their tax liability

Group legal service plans insure that participants will get legal counsel before their difficulties become disasters: before houses are lost or tenants are evicted, before cars are seized and utilities disconnected, before divorce or custody proceedings get out of hand. These plans improve productivity by helping employees quickly resolve legal difficulties that otherwise distract them, make them anxious or cause them to lose work time.

During the debate on welfare reform considerable attention was given to the issue of child support. Group legal services allows working mothers to secure legal help to make sure that they can recover child support from an absent father. It is pretty tough to hire an attorney for support orders that might yield a few hundred dollars per month. This benefit makes sure the mother and children keep the lion's share of the award.

Section 120 encourages employees to pay for preventive legal services for employees and their families. This section allows employees to exclude from their income the first $70 contributed by an employer to a qualified legal services plan.

Congress has extended §120 benefits seven times. A Treasury Department report stated that §120 and the group legal services plans they encourage helped middle income workers exactly as intended. Legal services plans have proven their value over the sixteen years that §120 had been in effect. These plans enjoy broad support from consumers, labor, the bar, and insurance companies.

Extension would cost under $100 million annually even assuming that without §120, none of the money now going to qualified legal plans would be diverted to other tax favored benefits.

Legal representation should not be the exclusive privilege of the wealthy. Working class families should have access to legal assistance for their personal problems too.

May 19, 1995

Mr. Phillip D. Moseley
Chief of Staff
Committee on Ways and Means
U. S. House of Representatives
1102 Longworth House Office Building
Washington, D. C. 20515

Dear Mr. Moseley:

I am writing to request the permanent extension of the tax exclusion for employer-provided educational assistance, as scheduled for discussion by the Subcommittee on Oversight of the House Ways and Means Committee on May 9, 1995.

As an employee, I have benefited enormously from my employer's education assistance plan. If not for tuition reimbursement, it is doubtful I would have had the financial resources to pursue my undergraduate degree. It was not financially possible for me to have funded my own education. To have waited a year or longer to deduct these expenses from income was not feasible.

In addition, because I was able to apply the tuition reimbursed from one semester of study to the following semester, very little out-of-pocket expense was incurred. And, without the education, it would be very difficult to advance in my chosen profession.

As an employer, I have also benefited greatly from our ability to help employees retain and gain the skills needed to remain successfully employed. As many other employers, we constant update processes to achieve greater efficiency. Many of our employees, who are in the middle-to-low income brackets, advance their skill levels with the help of our education assistance plan. They keep up with new technology and, therefore, continue to add value.

The tax exclusion permits a win-win-win situation for everyone. Our employees win because they achieve personal growth and can derive some comfort from knowing their skills are transferable. The company wins because

educated employees add value and enhance the products and services we provide. And, of course, our shareholders win as we are able to maintain our competitiveness in the marketplace.

The implications are larger than individual companies, too. As employees are trained or retrained by their employers, they gain valuable skills that will permit then to remain gainfully employed members of society. This is particularly important when you consider that the education system in this country is woefully lacking when compared with those of other industrialized nations.

Please continue to exclude from income amounts paid or incurred by an employer for educational assistance provided to an employee under Code Sec. 127, up to $5,250 per individual per year.

Sincerely,

Patricia A. Riccio

Patricia A. Riccio
Employee Benefits Manager

SUBMITTED FOR RECORD ONLY

WRITTEN TESTIMONY OF ROSEBUD SYNCOAL PARTNERSHIP

SUBMITTED TO THE SUBCOMMITTEE ON OVERSIGHT

OF THE COMMITTEE ON WAYS AND MEANS

HEARING DATE MAY 9, 1995

Chairperson Johnson, members of the Committee, Rosebud SynCoal Partnership is pleased to have the opportunity to submit testimony concerning the Production Tax Credit for Nonconventional Fuels (Section 29) and a possible extension of this credit. Rosebud SynCoal strongly supports a continuation of the Section 29 tax credit.

Rosebud SynCoal Partnership (Rosebud) is a general partnership between Scoria, Inc. an indirect subsidiary of Northern States Power Company, and Western SynCoal, a wholly owned subsidiary of Western Energy Company (WECO), an indirect subsidiary of The Montana Power Company. Rosebud owns and operates a 300,000 ton-per-year clean-coal demonstration facility at Colstrip, Montana. The SynCoal® product from that facility is eligible for the Section 29 tax credit.

Rosebud advocates a two-year extension of the "placed in service," "binding contract," and "production" deadlines in Code Section 29(g). Rosebud further believes that such an extension should be limited annually to the first one million tons of solid nonconventional fuels produced and sold from a qualifying facility at any one location and that these tax credits should not be negated by the application of Alternate Minimum Tax. A two-year extension of Section 29 and allowing the credits to offset AMT liability, together with a one (1) million tpy per facility per site cap, would allow companies the opportunity to demonstrate the technical scale-up potential to commercial scale of the involved technologies. This proposed cap is also large enough to allow for the capacity necessary to demonstrate market acceptance of the alternate fuel.

Rosebud believes that Congress created the Section 29 tax credit to recognize and help manage the substantial risk during the precommercial development stages of alternative energy projects. However, once commercialization is achieved the necessity for tax credits diminishes. Our experience and research suggest that nonconventional solid fuels from coal can be competitive with other fuels when those facilities can operate at two to three million tons-per-year of product produced and sold. A two-year extension of Section 29, and allowing the credits to offset AMT liability, together with a one million tpy cap would allow several promising technologies the opportunity to advance to the threshold of economic commercialization and is consistent with the original purposes of the Tax Credit for Nonconventional Fuels.

The federal budget issues currently facing our country make the fiscal impacts of any proposed extension a critical aspect of the legislative process. A limitation based upon facility size efficiently targets the incentive at a level appropriate to support technology development, while preventing abuse of this incentive as a tax shelter. Additionally, this approach leverages the incremental new public investment represented by the incentive against billions of dollars in prior strategic investments which have been made by both the public and private sectors under programs such as the Clean Coal Technology Program.

Rosebud and WECO have a long history in the development of alternative solid fuels. In the late 1960's and early 1970's, WECO conducted research into improving the

quality of low rank coals. Significant technical problems with this early work soon became apparent and WECO was unable to develop the technologies.

By the early 1980's, WECO became aware of a concept advanced by Mountain States Energy (MSE), the company that for many years operated the Department of Energy's (DOE's) Magneto Hydro Dynamics(MHD) research facility in Butte, Montana. WECO and MSE conducted bench tests on a process to remove moisture and sulfur that were promising enough to warrant the construction of a pilot plant. WECO built and operated a 130 lb/hr pilot plant in Butte. Results from the pilot plant led WECO to submit a proposal to the DOE in Round 1 of the Clean Coal Technology Program.

In June of 1990, negotiations between WECO and DOE concluded with the commitment to build and operate a $69 million, 300,000 tpy demonstration project at Colstrip, Montana. WECO then formed a partnership with Northern States Power that led to the formation of Rosebud. Construction began in December of 1990 with the demonstration operational phase beginning in April of 1992. The plant was declared to be in-service in August 1993.

The experience gained from bringing forth a new energy product from the concept stage to the threshold of market acceptance has given WECO and Rosebud valuable perspectives on the evaluation of new technologies. We also have gained an appreciation of the importance and the role of federal tax incentives and the time necessary to develop technology and markets for new products.

New energy technologies must go through several stages of development to prove viability. Bench scale tests of technological concepts must be followed by construction and operation of larger pilot plant facilities which, if successful, are then followed by even larger demonstration phases before commercial operations are possible. Attempts to shortcut these steps lead to unacceptable technical risk and increase the probability of failure. Some companies have attempted to shortcut the development process with devastating results.

Technology development activities require long lead times for planning, permitting, financing, construction and startup. Rosebud's experience has shown that a generous allowance of time is necessary to resolve the many unforeseeable issues that confront all technology developments. For example, Rosebud's demonstration plant took 15 months to shake out after initial startup and no amount of expenditures could have resolved these issues much sooner.

Following a measured development program increases the likelihood of success and mitigates risk. Federal tax credits play a role in the development of new technologies by mitigating market risk and allowing the private sector to fund and develop these technologies.

IRS has complicated Rosebud's developmental activities when they recently withdrew the private letter ruling qualifying Rosebud's current facility and took nearly a year to rule on two private letter ruling requests for the next generation developments. IRS did subsequently issue the requested rulings and has communicated that the withdrawn letter ruling will be reinstated. However, these actions have significantly increased the perceived project risk for next generation developments that are crucial to the ultimate commercialization of these technologies.

The attached development schedule is aggressive and shows why an extension of the inservice date and binding contract dates are necessary for continuing technology development.

Rosebud's plant is now operating at well over design capacity at high availabilities; however, the market has been slow to accept the new product.

Rosebud's experience has shown that once a new technology has successfully made the jump to small scale demonstration, market acceptance is critical to promote the technology's development to a commercial level. Utility and industrial fuel customers are concerned about reliable supply. In our case, their fuel needs are typically severely mismatched with the relatively small production capacity represented by an initial demonstration scale operation, such as our 300,000 tons per year facility.

This mismatch makes long-term commitments from the customers that are needed to support these facilities or next generation facilities nearly impossible because of the perceived physical supply risk being absorbed by the customer. However, without committed customers, these facilities cannot be financed or operated which, in turn, results in stagnation of the technology development. That is why the continuation of the Section 29 tax credits is so important.

If the Section 29 tax credit is extended by the 4th quarter of 1995, Rosebud plans to build two (2) next generation SynCoal production facilities, approximately 500,000 tons per year each. These facilities would allow Rosebud to scale up the technology to a scale of 3 to 5 times greater than the throughput design of our existing demonstration process reactors. This design threshold is intended to allow demonstration of static fluid bed reactor technology at one scale less than that required for full scale commercial deployment, but large enough to secure commercial fuel contracts with customers.

The specific projects are: 1) an expansion of the Colstrip, Montana demonstration site and 2) a plant integrated into Minnkota Power's M.R. Young power plant site near Center, North Dakota. These next generation projects would employ different aspects of the specific knowledge gained at the Colstrip demonstration project, providing efficient opportunities to advance the technology. These advances would allow further opportunities to gain the additional knowledge and experience necessary to ultimately commercialize this technology. At the same time these projects would result in construction investments totaling nearly $80 million, increasing the tax base, directly and indirectly they would provide approximately 400 new permanent jobs and increase economic activity by about $30 million per year.

The development activities of alternative fuel producers like Rosebud provide opportunities for the United States to take better economic advantage of our existing industrial and utility infrastructure while displacing imported foreign energy sources. These projects would produce value added products from low quality domestic feedstocks. They would continue the significant progress made in reducing environmentally threatening emissions while efficiently using our most abundant energy resource--coal.

When the United States Congress enacted Code Section 29 in 1980, it did so to encourage the domestic production of alternative fuel sources to decrease our dependence on the use of imported energy. In 1980 petroleum imports were 6365 Mbbl/day or 37.3 percent of our total petroleum use. By 1994, petroleum imports had grown to 8017 Mbbl/day or 45.5 percent of our total petroleum use. The projections for 1995 indicate that 53 percent of our petroleum needs will be met by imports. The original purpose for Section 29 is even more pressing today as the United States is demonstrating increased dependence on imported oil.

Nonconventional fuels like SynCoal® have shown a direct ability to displace petroleum products in both utility and industrial applications. SynCoal® has been used in place of natural gas and propane in direct fired kiln operations and has shown an ability to deslag utility boilers more effectively than fuel oil.

The U.S. Congress enacted Code section 29 in 1980 to encourage the domestic production of alternative fuel sources to decrease our dependence on the use of imported energy. Section 29 provides an incentive for the production and sale of fuels from designated non-conventional sources. The Senate Finance Report accompanying the enactment of Code section 29 stated that:

> The Committee believes that a tax credit for the production of energy from alternative sources will encourage the development of these resources by decreasing the cost of their production relative to the price of imported oil.
>
> **These alternative energy sources typically involve new technologies and some subsidy is needed to encourage these industries to develop to the stage where they can be competitive with conventional fuels.** Information gained from the initial efforts at producing these energy sources will be of benefit to the entire economy.[1]

Based on this legislative history, Rosebud believes that Congress originally intended to limit the credit to noncommercial scale production facilities. We submit that this original intent was proper and it forms the basis of our recommendation for a limited, targeted extension of Section 29.

Section 29 is a performance based incentive that only can be realized upon the sale of the nonconventional fuel product produced from the qualified facility. The taxpayer bears all technology and production risks and only receives the incentive after establishing its technical and operating capability and actually consummates a sale of the alternate fuels product. This structure minimizes the public's risk of providing incentives that do not provide the desired beneficial effects especially when limited to the production levels that support logical technology development.

An extension of Section 29 would provide important benefits for the United States. As mentioned previously, the evolution of a viable nonconventional fuels industry would contribute to the energy security of our nation. Additional benefits include further environmental and energy technology development that would assist in achieving compliance with Clean Air Act requirements, while providing additional employment for US workers. The successful development of a domestic nonconventional fuel industry would also lead to technology transfer in the international marketplace. Such endeavors would improve our trade deficits with other nations.

Rosebud believes there are important and compelling reasons to extend Code Section 29 and would urge this Committee and Congress to look favorably on a limited, targeted extension.

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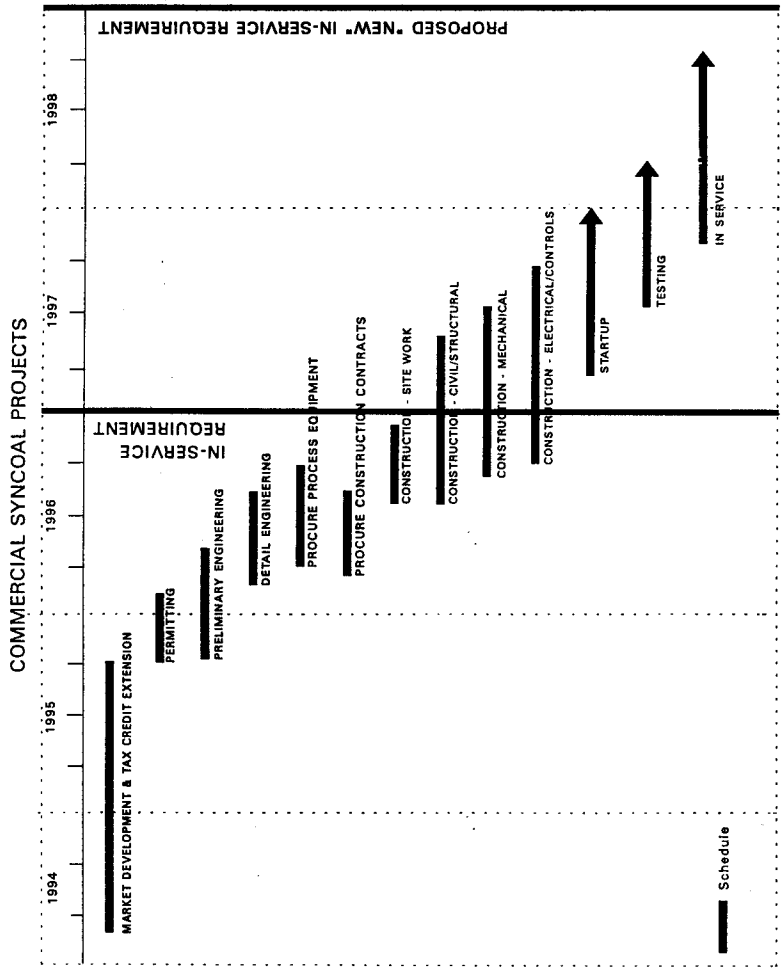
[1] S. Rept. No. 96-394, 96th Cong., 1st Sess. 87 (1979), 1980-3 C.B. 131, 205 (emphasis added).


COMMERCIAL SYNCOAL PROJECTS
1994
1995
1996
1997
1998
IN-SERVICE REQUIREMENT
PROPOSED "NEW" IN-SERVICE REQUIREMENT
MARKET DEVELOPMENT & TAX CREDIT EXTENSION
PERMITTING
PRELIMINARY ENGINEERING
DETAIL ENGINEERING
PROCURE PROCESS EQUIPMENT
PROCURE CONSTRUCTION CONTRACTS
CONSTRUCTION - SITE WORK
CONSTRUCTION - CIVIL/STRUCTURAL
CONSTRUCTION - MECHANICAL
CONSTRUCTION - ELECTRICAL/CONTROLS
STARTUP
TESTING
IN SERVICE
Schedule
Summary Timescale Schedule
TIMSCH-4/14/95

STATEMENT OF SAFETY-KLEEN CORP., ELGIN, ILLINOIS

Re-refining of Used Engine Oil

Safety-Kleen's Role in Managing Wastes

Safety-Kleen is the world's leading recycler of automotive and industrial hazardous and non-hazardous waste fluids. The Company processes and reclaims more than 200 million gallons of contaminated fluid each year collected from approximately 400,000 customers. The Company believes that only through proper handling can the hazardous waste portion of the world's wastes be safely managed to ensure the preservation of human health and the environment.

Safety-Kleen is exceptionally proud that the vast majority of its customer base is made up of small businesses, where jobs are being created and where the economy is having it's greatest current successes. Safety-Kleen's unique U. S. distribution system includes a network of 160 branches to collect wastes, 9 solvent Recycle Centers, one used oil processing facility and one used oil re-refinery to recycle, reclaim, or re-refine these wastes. Through these facilities, the Company provides services to customer locations throughout the United States.

The Company collects used lubricating oil from 64,000 customer locations in the U. S. These customers consist of car dealers, oil change outlets, gas stations automotive garages and many other small businesses. In addition, Safety-Kleen provides service to many of the nation's largest companies.

In short, Safety-Kleen teams effectively with small business, removing what used to be environmental and human health concerns and allowing those small businesses to do what they do best -- serve their customers and the economy.

Safety-Kleen's two used oil re-refineries in East Chicago, Indiana and Ontario, Canada processed approximately 112 million gallons of used oil during 1994. Since the majority of Safety-Kleen's customers are small businesses, the Company plays an additional key role beyond simply picking up used oil and other wastes. Safety-Kleen provides, as a matter of course, comprehensive and up-to-date information on the often complex environmental regulations and procedures with which its customers need to comply.

The Used Oil Issue

According to U.S. EPA figures, approximately 1.4 billion gallons of used oil are generated annually. Only about half of this amount is collected for recycling. Of the used oil collected, approximately 85% is burned as fuel and 15% is re-refined into base lube stock for reuse.

The adverse affects to the environment of improper disposal of used oil are as startling as they are well documented. One gallon of stray oil can render one million gallons of water undrinkable. Additionally, used oil frequently contains elevated concentrations of toxic metals, such as lead, which are picked up from contact with engine parts during use.

In response to the potential environmental damage posed by the improper management of used oil, the U.S. EPA promulgated used oil management standards in March, 1993, aimed at ensuring that used oil is managed in a manner that is fully

protective of human health and the environment. The used oil management standards appear in title 40 of the Code of Federal Regulations (CFR) part 279.

Although these regulations focus on proper management, they also recognize the value of used oil as a resource that can and should be reused, either through re-refining into lube stock or through burning as a fuel in appropriate units. Thus, the used oil management standards assume that used oil will be recycled, and are written in a manner to encourage collection and reuse.

Benefits of Re-refining

Officials with the U.S. EPA as well as significant elements of the environmental community have stated that re-refining is the preferred option for the recycling of used oil. Re-refining is considered by many "a higher use" than burning as fuel for energy recovery. Oil can be re-refined and re-used an unlimited number of times with no loss of quality, essentially renewing a resource once thought to be non-renewable. A state-of-the-art re-refinery, such as Safety-Kleen's East Chicago re-refinery, is capable of handling almost any used oil stream and converting it into quality lube stocks equivalent in all respects to virgin material.

Only two gallons of used oil are required to produce one gallon of lubricating oil, whereas, approximately 13 gallons of crude oil are required to produce one gallon of virgin lubricating oil. Re-refining also uses about one-third of the energy required to produce the equivalent amount of virgin lubricating oil. Thus, re-refining of used oil plays a role in reducing dependence on foreign energy sources and fossil fuels, both in regard to feedstocks used to produce lubricants and to energy requirements for the re-refining process.

The Re-Refining Process

Safety-Kleen's re-refineries use advanced technology (thin film evaporation and hydrotreatment which is the most evolved form of re-refining). This process provides the highest quality lube stock and produces the least amount of waste. In addition to the primary product, lube stock, the re-refining process also produces other useful products, such as asphalt extender, which is used in the manufacture of shingles or asphalt for roadways.

Safety-Kleen's re-refineries have pioneered many of the more innovative techniques used in re-refining. The promise of this new technology has led Safety-Kleen to invest in excess of $75 million of property, plant and equipment at the East Chicago, Indiana plant.

The Used Oil Industry

Safety-Kleen and Evergreen Oil Inc, of Newark, California produce the vast majority of re-refined oil in the United States. Re-refined oil makes up only about 15% of the total oil recycled in the country. At this time, the majority of used oil collected in the United States is processed for use as fuel by approximately 200 processing facilities. Both Safety-Kleen and Evergreen operate state-of-the-art re-refineries capable of producing quality lube stock that meets applicable industry standards for lubricants. Despite existing re-refiners success in producing quality products, the capital investment required to build or upgrade existing facilities into state-of-the-art re-refineries, coupled with slim profit margins, have generally discouraged entry into re-refining by other businesses.

In addition to raising the quality and the reputation of re-refined oil, Safety-Kleen's used oil collection and management procedures, which were modeled after the procedures it uses to manage hazardous waste, are the most stringent in the U.S. and have set a standard for environmental protection for the rest of the industry.

Quality of Re-refined Oil

Re-refining technology has made major advances over the past 15 years. The successful adaptation of refining technologies such as hydrotreating, a process which removes or destroys contaminants such as chlorinated compounds, allows the production of re-refined lube stock that meets or exceeds the standards set for lube stock refined from virgin oil.

Safety-Kleen has received International Standards Organization (ISO) 9002 accreditations for both its East Chicago and Breslau, Ontario, re-refineries. The Company's high-quality lube stock is blended, either by Safety-Kleen or by independent compounders-blenders or major oil companies, into a wide range of products. Safety-Kleen's own brand of engine oil made with re-refined lube stock is America's Choice, which is sold at Wal-Mart stores and other retailers.

Improvements in the quality of re-refined oil have led to increased market acceptance and interest. Several of the major oil companies are marketing their own brands of engine oil blended from re-refined lube stock produced by Safety-Kleen or Evergreen. Additionally, re-refined oil meeting the International Lubricant Standardization and Approval Committee's (ILSAC) GF-1 specifications received another important acknowledgement of its quality. The American Automobile Manufacturer's Association has stated that any oil, including re-refined motor oil, displaying the American Petroleum Institute's certification mark "starburst symbol" is suitable for use by its members (Chrysler Corporation, Ford Motor Company, and General Motors).

Both the U.S. government and a number of state governments are seeking to increase the market for re-refined oil by encouraging their own agencies to buy it through procurement preference guidelines. The U.S. EPA's Office of Solid Waste, Municipal and Industrial Waste Recycling Section, designated re-refined oil as an item that agencies should purchase in 1988 after careful review of its quality. Re-refined oil was also designated for preferential procurement by operating units (the Park Service, GSA, etc), of the Federal Government in an Executive Order 12873 on ***Federal Acquisition, Recycling, and Waste Prevention*** issued by President Clinton on October 20, 1993.

Additionally, in 1994, Safety-Kleen received the prestigious "Green Seal" certification for its re-refined engine lubricants. Green seal, an independent, non-profit organization, awards its certification to products found to cause significantly less harm to the environment than other, similar products.

Economics

Entry into the re-refining business has been expensive for Safety-Kleen. Factors that hinder entry into the business include high capital costs required to produce quality lube stocks, and the extensive and complex requirements covering regulatory compliance, operating permits and waste water discharges. The Company showed no return on its investment in the oil re-refining business from initial entry in 1987 until 1994, when a small profit was made.

Since the price of lube stock is tied to the cost of virgin crude, which has been relatively low over the past few years, profit margins are slim. The capital investment in the re-refineries and the cost of operating the Company's collection system represent fixed costs that cannot be adjusted downward.

Conclusion

Beyond the obvious benefits to small businesses nationwide and to the environment, government and industry endorsement of high-quality re-refined lube stocks, such as those produced by Safety-Kleen, underscores the importance of recycling used oil through re-refining. Because of the cost structure of the industry, however, re-refiners face stiff obstacles in order to produce re-refined products.

The process and promise of re-refining includes benefits to the environment as well as decreased reliance on imports. The hundreds of millions of gallons of used oil that have thus far been re-refined represent conservation of an important resource and protection of U.S. waterways and groundwater from improper disposal.

Re-refiners, who necessarily operate on a smaller scale than the major oil companies, are directly affected by the price of crude oil without the economies of scale of the major oil companies. Additionally, re-refiners must compete for used oil in the marketplace with used oil processors, or those organizations which convert used oil into fuels of various types. These oil processors naturally have lower levels of capital investment at a lower cost structure.

Thus, the extra costs associated with collecting and re-refining used oil are conceptually comparable to the costs associated with extracting crude oil from difficult-to-access deposits, or "non-conventional sources" and should be afforded comparable tax incentives.

In summary, we believe that a tax incentive as discussed here would have significant multiple benefits for the country; including helping our country's increasingly important small business community, helping to keep the environment clean for us and for future generations, and assisting an industry that can play an important role in helping America achieve true energy independence.

STATEMENT OF
SECTION 29 COALITION
ON SECTION 29 NONCONVENTIONAL FUELS TAX CREDIT

SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

May 9, 1995

The Section 29 Coalition supports the extension and improvement of the section 29 nonconventional fuels tax credit. The members of the coalition are companies involved in the production of gas from biomass and synthetic gas from coal or lignite.

Background of the Credit

The nonconventional fuels tax credit was enacted in 1980 as a means of encouraging the production of alternative forms of energy. The credit was set at $3.00 (plus an inflation adjustment) per barrel-of-oil-equivalent, and was designed to phase out during periods of high oil prices.

The principal effect of the credit during the 1980s was to stimulate the drilling of gas wells in eligible geological formations -- specifically, in tight sands, Devonian shale, and coal seams. However, Congress allowed the authorization for new wells in those formations to expire at the end of 1992. Gas produced from old wells in those formations will continue to qualify for the credit through 2002.

Refocused Credit

In the National Energy Policy Act of 1992, Congress extended the authorization for new energy "facilities" specified in section 29 -- specifically, for facilities used to produce gas from biomass or synthetic fuel from coal or lignite. To qualify under the 1992 extension, such a facility must be placed in service by the end of 1996, pursuant to a binding contract in effect by the end of 1995. Fuel produced in such a facility will qualify for the credit through 2007.

The net result of Congress's actions in letting part of section 29 expire and in extending the authorization for new facilities was to sharply refocus the credit. As refocused, the credit has essentially three effects: It promotes the production of clean fuels from coal and lignite; it promotes the recovery and productive use of methane produced in landfills; and it promotes the production of gas from other biomass -- such as wood waste.

The credit has helped stimulate the commercial development of coal gasification technology, under which high-sulphur coal or lignite can be efficiently transformed into a clean-burning gas. The first commercial-scale coal gasification facilities to be used in this country by electric utilities in power generation are scheduled to go into service in the next year. The success of the projects could lead to widespread use of coal gasification in the next century as a replacement for aging conventional coal-fired power plants. Compared to a conventional power plant, a power plant fueled with synthetic gas from coal or lignite will reduce emissions associated with acid rain to levels far below Clean Air Act standards, while also sharply reducing carbon dioxide emissions.

Similarly, the credit has stimulated more than 100 projects around the country to recover and use the methane gas generated in the decomposition of organic material in landfills. In the typical case, the gas is used on the landfill site to generate electricity. In other cases, the gas is piped off-site to an industrial plant or other gas consumer. Most of the projects are small, but, in their absence, the gas would simply be wasted. In cases where the landfill operator does not sell the landfill gas, the operator will collect sufficient quantities of the gas to prevent gas migration, and will flare the collected gas. The credit has encouraged companies to develop the technology to efficiently recover and use the landfill gas, thereby preventing the waste of a valuable resource.

Recommendations

The job of the section 29 credit is not finished. In the next century, gasification has the potential to be the preferred technology for the clean use of coal and similar fuels in generating electricity. Gasification is both cleaner and more efficient than conventional technologies. But because of the enormous cost of commercial-scale gasification facilities, the commercial feasibility of the technology needs to be demonstrated thoroughly before many utilities will be able to take the risk of adopting the technology. An extension of the authorization period for the section 29 credit would encourage more utilities to adopt the technology in the near future. The commercial feasibility of the technology could be fully demonstrated by early in the next century.

The credit also is needed as a continuing stimulus to encourage landfill owners to recover and use the methane gas produced in landfills. Many landfills around the country remain as possible candidates for landfill gas recovery and use, and new landfills will continue to come on line. The EPA has long promoted, and continues to promote, the environmental benefits of landfill gas recovery and use. Currently, the EPA is engaged in these efforts through its Landfill Methane Outreach Program. The section 29 credit not only is consistent with that program, but is essential to its success.

To ensure the continued benefits of the section 29 credit, Congress should extend the authorization period for new section 29 facilities for another four years. As a practical matter, if the authorization period is not extended for at least four years, the credit will provide no incentive for companies to construct coal gasification facilities or other such major projects because of the multi-year lead-times for those projects. In conformity with the four-year extension of the authorization period, Congress also should extend the 2007 date for the availability of the credit for four more years, through 2011.

Congress also needs to improve the credit in two respects:

First, Congress should amend the unrelated person sale rule to eliminate unnecessary red tape. Section 29 requires producers of eligible fuel to sell the fuel to unrelated persons to qualify for the credit. That rule creates an unnecessary burden in cases where an eligible fuel is best used on the site of production for the generation of electricity. For example, if a utility produces synthetic gas from coal and desires to use it on site to generate power, the utility must enter into an arrangement under which a third party will own either the gasification unit or the power generation unit; an unrelated person sale of the gas will result. Clearly, the tax law should not force taxpayers to take artificial steps such as this in order to take advantage of the credit. The Treasury has previously testified that the administration does not oppose eliminating the unrelated person sale rule. We suggest eliminating the rule in cases where the taxpayer uses fuel on the site of production to generate electricity and sells the electricity to unrelated persons; in those cases, the sale of the electricity can serve as an arms-length indicator of the volume of energy used and produced.

Second, Congress should clarify that the credit applies to synthetic fuels produced from petroleum coke, as well as from coal and lignite. Like coal and lignite, petroleum coke is a solid, impure, organic substance that can be used for fuel. Its heating value is higher than that of most coals, while its ash and moisture content are lower. A byproduct of petroleum refining, petroleum coke is produced in ever larger quantities because of the declining quality of the world's oil supply, while, at the same time, its continued utilization as a fuel is of increasing environmental concern due to its high sulfur content. The inclusion of petroleum coke in section 29 would provide an incentive for companies to demonstrate the gasification of the material on a commercial scale, thereby converting petroleum coke to a clean-burning fuel for use in the next century.

Summary

The section 29 credit represents an efficient mechanism for encouraging the development of alternative energy technologies, including technologies that let companies sharply reduce emissions associated with acid rain to meet the tightening Clean Air Act standards. Congress should extend the credit for another four years and also adopt appropriate amendments to improve the credit.

SMITHFIELD FOODS, INC.

IN SUPPORT OF THE

TARGETED JOBS TAX CREDIT (TJTC) PROGRAM

Smithfield Foods, Inc. is a $1.8 billion pork processor primarily located in the Mid-Atlantic United States with peripheral operations in Wisconsin and Utah. The Company operates numerous meatpacking plants throughout these regions employing large numbers of unskilled and semi-skilled workers for the work requirements of the meatpacking industry. The job positions, while not requiring extensive educational background, do require significant on-the-job training after hire date in order for the individual worker to be proficient and efficient in the production process. Meatpacking jobs lend themselves to the lesser skilled individual and provide prime possibilities for TJTC eligible people.

Under this program, Smithfield has put more than 600 people to work over the past few years who might otherwise have remained unemployed and on the welfare roles. This program has come under sharp criticism recently from the Labor Department for its supposed inefficient and wasteful nature. This claim, while always a possibility with any incentive program of government, is not the case with Smithfield Foods, Inc. Since 1981, Smithfield Foods, Inc. has actively recruited the hard-to-hire person utilizing the TJTC program as a key screening process. This program has been used to hire those who otherwise would not have been hired by our Company. This program has resulted in Smithfield actively pursuing employment of work release prisoners and disadvantaged youths as well as social services dependent welfare recipients.

In contrast to allegations made by the DOL that these people would be hired anyway, Smithfield has actively offered an alternative for convicted felons, to give them a job while imprisoned that continues after their release. Our success rate in retaining these employees after their imprisonment period has been good. We have in no way attempted to churn TJTC employees with other TJTC people once the credit has run, but rather have made every attempt to retain employees; the very nature of our business dictates retaining a trained workforce to the extent we possibly can. In addition, DOL has alleged that TJTC people are hired on a part-time basis with little or no benefits, I again challenge this premise. The vast majority of TJTC persons at Smithfield Foods are full-time, 40-hours plus employees and all employees receive a full compliment of benefits including vacation, health and life insurance and attendance bonuses. I have attached to this letter some statistics supporting our utilization of the program which I ask be reviewed and considered as well as specific case analysis of people hired who have remained long after the credit has expired.

I feel it unfortunate that a program that can work and does work to improve society is likely to be eliminated. I am not embarrassed to admit that Smithfield Foods, Inc. has benefitted from these tax credits over the past years; this is the reason the program was enacted. I do, however, feel very strongly that in the case of our Company, the program has worked exactly as it was supposed to. A tax credit program was passed as an incentive for industry to hire those members of society with limited skills and problem backgrounds. In return for this, industry is rewarded with a modest financial incentive in the form of tax credits for hours worked. This is a successful program, both for industry and for society.

This is not a wasteful program, and properly structured, this can be an important avenue for those seeking real gainful employment. I urge your support for renewal of the program and thank you for your time and consideration.

C. Larry Pope
Controller

The following information is being submitted in an effort to provide an optimistic view regarding the future of the Targeted Jobs Tax Credit (TJTC) Program. This information not only voices our support for the program, but outlines procedures which we have implemented that have proven to be effective in accomplishing objectives in both the public and private sectors.

Smithfield Foods, Inc. has been a long time participant in and supporter of programs that were created to provide assistance for disadvantaged individuals. We recognize the importance of a cooperative relationship between the public and private sectors and actively strive to maintain this relationship. The proactive measures we have taken to become involved with public service agencies and their purposes clearly demonstrate our concern and dedication to becoming an integral part of the solution to many problems we face when attempting to provide assistance for the less fortunate. Our most important resource is our human resource. The very nature of our business requires that we employ, train and retain a productive workforce. Through the TJTC program we are able to provide employment opportunities for disadvantaged individuals who may only need just that, "the opportunity".

As stated in the Department of Labor's TJTC ET Handbook 377, "TJTC is intended to further the partnership between the employment and training system and the private sector in dealing with problems of the disadvantaged and unemployed. TJTC is a significant part of this effort and a cost-effective way of increasing private sector employment opportunities. It offers taxpaying businesses incentives to increase the number of job opportunities available to the disadvantaged and to retain these workers in the critical first year of employment". The purpose and objectives behind this program could not be more appropriate. Especially when our country faces problems concerning unemployment and Welfare Reform. We do not feel that problems that may appear to exist with TJTC are within the structure of the program itself, but in the manner in which the program is implemented. Proper implementation requires teamwork and effort on the part of both the private and public sectors. We have recognized this deficiency. We have created and implemented a new approach that has proven to be mutually beneficial in both sectors.

In 1993, the position of Human Resources, Government Incentive Program Coordinator (GIPC) was implemented in one of our facilities. The results have been extremely successful and we are considering implementation on a corporate level. The primary responsibility of this position is to act as a liaison between the company and the public sector in the Human Resources arena. A Coordinator was hired into this position and brought with him seven (7) years of pubic sector experience in programs designed to assist

disadvantaged individuals in finding employment. Knowledge and experience in both the private and public sectors have proven to be the key ingredients in eliminating existing obstacles that may inhibit proper program implementation and prevent any private sector employer from utilizing programs in the manner in which they were intended.

The following information outlines the responsibilities of the GIPC. These are essential components attributed to our success.

* **EDUCATION**

  Educating the Human Resources Department on the purpose of TJTC and other Government Programs.

* **PUBLIC RELATIONS**

  Creating and actively maintaining positive working relationships with all public service agencies charged with the responsibility of assisting disadvantaged individuals in becoming gainfully employed (i.e. Department of Social Services, Department of Corrections, Department of Rehabilitative Services, JTPA Agencies, etc.)

* **RECRUITMENT**

  Presentations at the above-mentioned agencies for clients who are job-ready and are actively seeking employment. These presentations educate clients on our industry and the types of employment available.

* **ASSESSMENT**

  Potential employees are referred for individual assessment. Topics are discussed such as requirements necessary to become and remain employed, reliable transportation, and what positions might be most suitable for the client based on their needs. If deficiencies exist that absolutely prevent an individual from being considered for employment (i.e. no transportation), suggestions are offered on how the obstacle may be overcome.

* **ELIGIBILITY DETERMINATION**

  Potential employees are screened for TJTC eligibility and informed of other programs that can be of assistance when seeking employment with any employer. Individuals who have demonstrated a strong desire for opportunity will be considered for employment as vacancies arise.

* **RETENTION**

  Once individuals are employed, they are informed that the GIPC is always available for assistance should problems arise during their employment. They are encouraged to discuss potential problems with the GIPC in an effort to resolve them before they become problems that may affect their employment.

The following statistics and employment profiles justify the information presented above and strongly contradict the negative results and criticism produced by the investigation conducted by the Office of the Inspector General (OIG).

SMITHFIELD FOODS, INC.
ANALYSIS OF TJTC PROGRAM
HISTORY OF EMPLOYEES HIRED

TARGET GROUP	1994	1993	1992	1991	1990
A - Vocational Rehabilitation Referral	3	2	2	-	1
B - Disadvantaged Youth (Age 18 - 22)	100	56	30	4	-
C - Disadvantaged Vietnam Era Veteran	8	3	-	-	5
D - Supplemental Security Income Recipient	3	3	-	1	-
E - General Assistance Recipient	2	1	3	-	-
F - Disadvantaged Youth Participating in a Cooperative Education Program	-	-	-	-	-
G - Disadvantaged Ex-Offender	66	37	63	15	-
H - Eligible Work Incentive Employee or AFDC Recipient	83	35	61	16	-
J - Qualified Summer Youth	1	-	-	-	-
	264	137	159	36	16

Total employees hired under the program over the past five years 612

THE FOLLOWING IS A SMALL SAMPLE OF EMPLOYMENT PROFILE SUMMARIES FOR INDIVIDUALS WHO WERE HIRED INTO COMPANIES WITHIN SMITHFIELD FOODS, INC. UNDER THE TARGETED JOBS TAX CREDIT (TJTC) PROGRAM. PERSONAL/CONFIDENTIAL INFORMATION IS BEING WITHHELD IN ACCORDANCE WITH THE PRIVACY ACT.

EMPLOYEE #1

HISTORY:	* Female - 18 years of age * Single mother * Previous work history - none * Department of Social Services referral AFDC and Food Stamp Recipient * High School/GED - Yes
ASSESSMENT/ SCREENING:	10/25/93
TARGET GROUP:	B - DISADVANTAGED YOUTH (18-22 yrs. old) H - AFDC RECIPIENT
START DATE:	10/27/93
STARTING WAGE:	$ 6.00
CURRENT WAGE:	$ 7.58
BENEFITS:	Yes
COMMENTS:	Employee has been employed for 1 year and 6 months. She is currently employed in our Cut Department, self-sufficient and has not had to return to the welfare system.

EMPLOYEE #2

HISTORY:	* Male - 48 years of age * Married, father of one * Previous work history - Military USAF * High School/GED - Yes
ASSESSMENT/ SCREENING:	8/13/93
TARGET GROUP:	C - DISADVANTAGED VIETNAM ERA VETERAN
START DATE:	9/20/93
STARTING WAGE:	$ 5.96
CURRENT WAGE:	$ 7.56
BENEFITS:	Yes
COMMENTS:	Employee has been employed for 1 year and 7 months. He has been re-trained to be a skilled production worker in the meat production industry.

EMPLOYEE #3

HISTORY:	* Male - 33 years of age * Single * Previous work history - Construction (sporadic) * Department of Corrections referral * High School/GED - Yes
ASSESSMENT/ SCREENING:	9/13/93
TARGET GROUP:	G - DISADVANTAGED EX-OFFENDER
START DATE:	9/20/93
STARTING WAGE:	$ 5.96
CURRENT WAGE:	$ 7.58
BENEFITS:	Yes
COMMENTS:	Employee was incarcerated 11/89 - 8/93. Upon release, he was referred for employment. After demonstrating a strong desire to "make it work" he was provided an employment opportunity, trained and continues to be a productive employee in our AB Pack Department.

EMPLOYEE #4

HISTORY:
* Female - 31 years of age
* Single mother
* Previous work history - Retail (last employment 5/88)
* Department of Social Services referral
* High School/GED - Yes

ASSESSMENT/ SCREENING: 8/06/93
TARGET GROUP: H - AFDC RECIPIENT
START DATE: 9/20/93
STARTING WAGE: $ 5.96
CURRENT WAGE: $ 8.06
BENEFITS: Yes

COMMENTS: Employee has been employed for 1 year and 7 months. Previously, she had not been gainfully employed for over 5 years. She is currently employed in our AB Pack Department and has substituted as Crew Leader on occasion.

EMPLOYEE #5

HISTORY:
* Male - 24 years of age
* Disabled
* Previous work history - Varied, not working more than 4 months in one location.
* High School/GED - No

ASSESSMENT: 11/09/94
TARGET GROUP: D - SUPPLEMENTAL SECURITY INCOME RECIPIENT
START DATE: 11/12/94
STARTING WAGE: $ 6.17
CURRENT WAGE: $ 7.70
BENEFITS: Yes

COMMENTS: Employee has been employed for 5 months. He was hired in our Plant Clean-Up Department responsible for sanitation according to USDA regulations. He has recently been promoted to Crew Leader.

SOUTHWEST AIRLINES
PILOTS' ASSOCIATION

Phillip D. Mosely
Chief of Staff
Committee on Ways & Means
1102 Longworth HOB
Washington, D.C. 20515

Dear Mr. Mosely:

On behalf of the approximately 2,000 pilots of Southwest Airlines, I am writing to request that the October 1st imposition of commercial jet fuel taxes be not simply postponed but removed from current law entirely.

The airline industry has, as a whole, recently begun to show some signs of improvement. Unfortunately, this improvement is marginal at best. The industry hasn't made a profit in 5 years. Analysts expect, but will not guarantee, a profit for the industry in 1995. The projected return on investment for 1995 is minimal, less that 1%, whereas a good return for American industry as a whole is in excess of 5%.

The 'return' of profits is not universal. Numerous airlines are struggling, notably Continental, USAir and TWA, not to mention Reno Air, Kiwi, Midway and others. The imposition of fuel taxes will make their fight to survive almost insurmountable - and extinct carriers pay no taxes.

Employee groups have made many sacrifices in an effort to return their carriers to some semblance of profitability. United, Northwest and TWA are examples wherein labor groups gave up tens and hundreds of millions of dollars in wage concessions. USAir is struggling to survive and its unions are working on a package of wage cuts and concessions at this time. Continental and America West employees have had no contracts or raises in years. At SWA, our pilots recently accepted a contract with no scheduled raises for five years. Are our sacrifices for the sake of our employers to be sacrificed? If that isn't enough, 120,000 airline employees have been cut or furloughed since 1990 - and the cutting is not yet finished.

In 1990 Congress increased taxes and authorized airports to begin charging Passenger Facility Charges. These two items alone added a further burden of $2 billion dollars annually to an industry losing hundreds of millions of dollars each year. The fees and taxes imposed by Congress are required to be paid regardless of profitability. Since 1990 the industry has lost an incredible $12.8 billion! Passenger and cargo taxes total over $6 billion annually. Is there something wrong with this picture?

This fuel tax, if imposed, is estimated to cost the industry some $527 million annually. The cost to Southwest Airlines will be approximately $30 million - double our profit in the first quarter. Can SWA and the other carriers pass this cost on to the consumer through higher fares? The answer, simply put, is NO. The industry is going through what most analysts consider one of the final phases of deregulation, one in which competition is severe. Fares simply cannot be raised in this market. The end results will be lower profits for some and larger losses for most, with predictable economic consequences.

The airline industry is beset with serious financial, labor, and competitive difficulties. The National Airline Commission recommended NO to the 4.3 cents-per-gallon fuel tax. And so, too, do the pilots of Southwest Airlines.

We strongly recommend this untimely tax be laid to rest. Please repeal the onset of the October fuel tax on the basis of good economic policy, not just for Southwest Airlines, but for the entire industry, their employees and the nation as a whole.

Sincerely yours,

Gary L. Kerans
President

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THE RESEARCH AND EXPERIMENTATION TAX CREDIT AND THE ALLOCATION OF RESEARCH EXPENSES UNDER INTERNAL REVENUE CODE SECTION 861

HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

OF THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDRED FOURTH CONGRESS

FIRST SESSION

MAY 10, 1995

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SUBMISSIONS FOR THE RECORD

THE RESEARCH AND EXPERIMENTATION TAX CREDIT AND THE ALLOCATION OF RESEARCH EXPENSES UNDER INTERNAL REVENUE CODE SECTION 861

WEDNESDAY, MAY 10, 1995

HOUSE OF REPRESENTATIVES,
COMMITTEE ON WAYS AND MEANS,
SUBCOMMITTEE ON OVERSIGHT,
Washington, D.C.

The subcommittee met, pursuant to call, at 10:15 a.m., in room 1100, Longworth House Office Building, Hon. Nancy L. Johnson (chairman of the subcommittee) presiding.

[The advisory announcing the hearing follows:]

ADVISORY

FROM THE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON OVERSIGHT

FOR IMMEDIATE RELEASE
April 19, 1995
No. OV-7

CONTACT: (202) 225-1721

JOHNSON ANNOUNCES HEARING ON THE RESEARCH AND EXPERIMENTATION TAX CREDIT AND THE ALLOCATION OF RESEARCH EXPENSES UNDER INTERNAL REVENUE CODE SECTION 861

Congresswoman Nancy L. Johnson (R-CT), Chairman, Subcommittee on Oversight of the Committee on Ways and Means, today announced that the Subcommittee will hold a hearing to examine issues relating to the research and experimentation (R&E) tax credit and the temporary rule for allocating research expenses between U.S. and foreign source income under Internal Revenue Code section 861. **The hearing will take place on Wednesday, May 10, 1995, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 10:00 a.m.**

BACKGROUND:

Section 41 of the Internal Revenue Code provides for a research and experimentation tax credit equal to 20 percent of the amount by which a taxpayer's qualified research expenditures for a taxable year exceed its base amount for that year. The R&E credit, which was enacted on a temporary basis in 1981, has been extended several times since, most recently in the Omnibus Budget Reconciliation Act of 1993 (the "1993 Act"). The credit is currently scheduled to expire after June 30, 1995.

The 1993 Act also provided a temporary rule for allocation of research expenses between U.S. and foreign source income. The 1993 Act rule generally is identical to temporary rules in effect prior to the 1993 Act for allocating research expenses, except that the portion of U.S.-incurred research expenses allocated to U.S. source income (and the percentage of foreign-incurred research expenses allocated to foreign source income) is 50 percent instead of 64 percent. The 1993 Act's temporary rule generally expires for taxable years beginning after August 1, 1994.

Chairman Johnson and Ranking Democrat Robert Matsui have sponsored H.R. 803, a bill to extend permanently the R&E credit. In announcing the hearing, Chairman Johnson stated, "Before Congress moves forward on legislation to extend the credit, I believe it's critically important to evaluate whether the credit's current structure is effective in achieving the goal of stimulating long-term research activities, and to examine proposals for improving its design to better meet the rapidly changing circumstances of global competition."

FOCUS OF THE HEARING:

The Subcommittee on Oversight will examine the effectiveness of the current credit and possible structural modifications to improve its utility in stimulating long-term research and experimentation activities. The current research credit is incremental in nature, rewarding companies for increasing their research expenditures (as a portion of gross receipts) above the average expenditures they made (as a portion of gross receipts) during the period from 1984 through 1988. To the extent that companies' current year research expenditures are significantly below or far above their base spending amounts, the credit becomes a less efficient policy tool.

In particular, the Subcommittee is interested in receiving testimony regarding the effectiveness of the current credit in stimulating long-term research and experimentation activities and regarding potential alternatives to the current structure of the credit, such as giving taxpayers some choice over their base period, or doing away with the base completely and providing a lower rate of credit on all qualified expenditures. In addition, the Subcommittee will receive testimony on whether the 1993 Act's temporary rule for allocating research expenses between U.S. and foreign source income should be extended.

SUBCOMMITTEE ON OVERSIGHT

DETAILS FOR SUBMISSIONS OF REQUESTS TO BE HEARD:

Requests to be heard at the hearing must be made by telephone to Traci Altman or Bradley Schreiber at (202) 225-1721 no later than the close of business, Friday, April 28, 1995. The telephone request should be followed by a formal written request to Phillip D. Moseley, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. The staff of the Subcommittee on Oversight will notify by telephone those scheduled to appear as soon as possible after the filing deadline. Any questions concerning a scheduled appearance should be directed to the Subcommittee staff at (202) 225-7601.

In view of the limited time available to hear witnesses, the Subcommittee may not be able to accommodate all requests to be heard. Those persons and organizations not scheduled for an oral appearance are encouraged to submit written statements for the record of the hearing. All persons requesting to be heard, whether they are scheduled for oral testimony or not, will be notified as soon as possible after the filing deadline.

Witnesses scheduled to present oral testimony are required to summarize briefly their written statements in no more than five minutes. **THE FIVE MINUTE RULE WILL BE STRICTLY ENFORCED. The full written statement of each witness will be included in the printed record.**

In order to assure the most productive use of the limited amount of time available to question witnesses, all witnesses scheduled to appear before the Subcommittee are required to submit 200 copies of their prepared statements for review by Members prior to the hearing. **Testimony should arrive at the Subcommittee on Oversight office, room 1136 Longworth House Office Building, no later than 5:00 p.m. on Friday, May 5, 1995.** Failure to do so may result in the witness being denied the opportunity to testify in person.

WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE:

Any person or organization wishing to submit a written statement for the printed record of the hearing should submit at least six (6) copies of their statement, with their address and date of hearing noted, by the close of business, Wednesday, May 24, 1995, to Phillip D. Moseley, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements wish to have their statements distributed to the press and interested public at the hearing, they may deliver 200 additional copies for this purpose to the Subcommittee on Oversight office, room 1136 Longworth House Office Building, at least one hour before the hearing begins.

FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages including attachments.

2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.

3. A witness appearing at a public hearing, or submitting a statement for the record of a public hearing, or submitting written comments in response to a published request for comments by the Committee, must include on his statement or submission a list of all clients, persons, or organizations on whose behalf the witness appears.

4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and the public during the course of a public hearing may be submitted in other forms.

Note: All Committee advisories and news releases are now available over the Internet at 'GOPHER.HOUSE.GOV' under 'HOUSE COMMITTEE INFORMATION'.

*****

Chairman JOHNSON. The hearing will come to order.

Good morning, ladies and gentlemen. Yesterday, the subcommittee received testimony on over half a dozen narrow provisions of the tax law which have either expired or will expire in the near future. Our mission is to review the policy objective of each provision and evaluate whether or not the provisions are meeting the objectives.

In the past, many of these were extended routinely without examining the actual structure of the provision. In fact, we never did routinely have hearings on expiring provisions. At this time in the committee's history, we are going to methodically not only hold hearings, but reevaluate the structure of the provisions and the relevance of the policy behind them, not only to this year, but to the next decade.

In the subcommittee today, we will continue this process by focusing on two very important but very complicated tax provisions which are meant to encourage research and experimentation by American businesses. Section 41 of the Internal Revenue Code provides a 20-percent tax credit for taxpayers who spend money on qualified research expenditures. The research credit first was enacted on a temporary basis in 1981. The level of the credit and the structure of the credit have been changed several times since 1981.

The challenge is twofold. First, we want to design a credit which stimulates more research activity rather than just rewarding a taxpayer for research activity which would have occurred anyway. This policy objective is what lies behind the decision to structure the credit to apply only to incremental increases in the taxpayer's research activity. The technical details of implementing this policy involve establishing base periods which serve as a reference point for measuring the amount by which a taxpayer has increased his research activity. Second, we need to be mindful of the revenue effect of the research credit.

The concept of an incremental credit and the limitation on unusually high research expenditures are both meant to hold down revenue losses. The current section 41 uses a fixed base period as the reference point to determine whether or not a taxpayer has increased his research activity enough in order to be eligible for the incremental credit. One side effect of this feature is that some taxpayers may not be able to qualify for credit because their base period is unusually high and so their current research spending never passes the incremental test in section 41. It seems unfortunate to exclude deserving research programs from the credit merely because of an accident of timing or how their law defines the base period or the economic experience of their company in succeeding years.

The subcommittee also will receive testimony regarding the rules applicable to allocating research expenditures between domestic and foreign-source income. American research activity has kept our Nation at the cutting edge of high technology. It helps maintain our high standard of living essential for our economy to grow in the 21st century.

We want to do all we can to encourage our businesses to expand their research effort and therefore we will not be looking just at renewing the research and development tax credit, but also the possi-

bilities of restructuring and the costs associated with those restructuring proposals.

I yield to my colleague and ranking member, Mr. Matsui.

Mr. MATSUI. I thank the Chair for her comments, and I appreciate the fact that she is holding these hearings on both section 861 and the renewal of the R&D credits. Since 1981, when the credit was first established in this country, it has been modified four times and extended six times. Obviously that creates major problems for U.S. businesses, in the sense of the issue of certainty. As a result of that, I welcome the opportunity to try to make these credits eventually permanent.

Almost all studies indicate that these credits reduce not only the cost of doing business, but also they stimulate over $1 for each $1 spent in terms of additional research and development over the short term. In the long term, they produce $2 for every $1 spent in the area of R&D. This obviously is an important stimulus to U.S. industry, and this credit, as a result of that, must be continued.

Thirty-four Governors have supported the credit, over 200 major companies that use the credit seek its permanent extension, and U.S. companies spend $75 million a year on R&D, and they need to continue and have an incentive to continue to be competitive in the world market.

Our major trading partners—Japan, for example, provides a 20-percent incremental credit up to 10 percent of their current tax liability; Canada provides a flat rate credit of 20 percent; and Germany provides incentives through grants, special depreciation allowances for equipment, and deductibility for their R&D expenses. So Canada, Japan, Germany, our major three trading competitors and partners, along with the United States, all have credits.

As the Chair has indicated, we must look at restructuring this credit as we make it permanent. The base period was established between 1984 and 1988, and for some research-intensive companies, this credit is not as helpful as it could be; and as a result of that, it is my hope that we could not only modify it, but also make it permanent.

In terms of the 861 allocation rules, yesterday we heard from the Treasury Department, and they have indicated that soon they will be coming out with new regulations that would be more favorable to the taxpayers than the 1977 regulations. It will be important that we hear from witnesses regarding Treasury's comments, and also, hopefully, we will be seeing Treasury's recommendations very shortly.

Again, I look forward to working with the Chair and other members of this subcommittee and the full committee on restructuring and making permanent these two very, very important aspects of U.S. competitiveness.

Thank you.

Chairman JOHNSON. I thank my colleagues for testifying today and welcome you to our hearing Hon. Anna G. Eshoo.

STATEMENT OF HON. ANNA G. ESHOO, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Ms. ESHOO. Good morning, Madam Chairwoman, and thank you to each of the members of the subcommittee for this opportunity to testify before you. I would like to commend you for holding hearings on this all-important issue on the research and development tax credit, which is of course a crucial tax provision which encourages companies to invest in new products and manufacturing technologies in return for a reduced tax burden.

I would also like to salute my colleague, Bob Matsui of California, who has been a tireless advocate of the R&D tax credit.

Last Congress, Members on both sides of the aisle succeeded in retroactively authorizing the R&D tax credit for 1 year, as well as extending it for an additional 2 years. We did this for one simple, good reason; the R&D tax credit works. It has proven to be a cost-effective way to create jobs and innovative products.

Now it is time, I believe, to make this tax credit permanent, and I am proud, Madam Chairwoman, to be an original cosponsor of your bill, H.R. 803, which would achieve this goal.

Many of us from California recognize that tax incentives create jobs and capital investment in the high technology and biotechnology industries. Many of these businesses are located in my congressional district, which is so distinguished, the home of Silicon Valley, and which boasts the most biotechnology, computer, and software companies of any region in the United States.

The tax experts of these companies have told me that when this tax credit was first implemented in 1981, they believed that they would finally receive the necessary incentives to reinvest or to invest R&D dollars at the level of their international competitors, and they were right. Today, computer and software companies reinvest on average 13 percent of their sales revenues in R&D, compared with a 7-percent average for U.S. businesses overall. The reinvestment rate is even higher for biotechnology companies, which put 30 to 60 percent of their revenues into R&D.

These investments have produced substantial economic growth, exactly the outcomes that we want to produce by keeping it on the books and also making it permanent. Between 1972 and 1992, the average growth rate for computer and software technology companies was approximately 27 percent, over nine times the growth rate of the national economy during that period. I think the figures are most provocative and tell the best story.

Not surprisingly, software, computer, medical, and biotechnology firms are driving job growth throughout the country, and these are very good paying jobs for our people. Yet with this success, the R&D tax credit has been extended for just months at a time. This is a short-term tax plan, and I think that it undermines the economic growth we are trying to promote.

Research and development requires long-term planning and financial stability in order to succeed. In other words, the companies that do this need to have something that is reliant, a reliant public policy. These legislative stops and starts weaken the high technology industry's ability to use this tax provision effectively. I urge this subcommittee to improve the effectiveness of the R&D tax

credit by removing the uncertainty which results from these short-term extensions.

I believe H.R. 803 accomplishes this goal by making the credit permanent, and I urge its swift passage.

I would also like to offer my support for two additional tax provisions important to the high technology community. The first is making retroactive, extending, and making permanent the research expense allocation rule which allocates 50 percent of U.S. research expenses to U.S. source income—this expired provision encourages companies to spend their research dollars in our country and is an important complement, I believe, to the R&D tax credit—and finally, to review the proposal to improve the existing tax credit by extending it to teams of companies and not-for-profit scientific research organizations. Because more and more research is now being done under the umbrella of not-for-profits and consortia, this could greatly improve the effectiveness of the R&D tax credit.

Let me thank you again, Madam Chairwoman, for your leadership on this issue and so many others, to all of the members of the subcommittee, and most especially for holding this very important hearing on this all-important issue for the future competitiveness and growth of our Nation.

Thank you.

Chairman JOHNSON. Thank you very much.

Mr. Neal, a valued member of our committee, a colleague.

STATEMENT OF HON. RICHARD E. NEAL, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MASSACHUSETTS

Mr. NEAL of Massachusetts. Thank you very much, Madam Chairperson, and members of the subcommittee.

Yesterday, Madam Chairperson, I would note that you made reference to Elvis during your opportunity to testify, and every time that Elvis had a chance, he brought up his support for making the R&D credit permanent.

Chairman JOHNSON. I am glad to know that.

Mr. NEAL of Massachusetts. We monitored that very carefully.

Let me thank you and commend you this morning, Mrs. Johnson, for holding this hearing. This credit is due to expire on June 30, 1995. You and I have worked with the New England delegation, as well as The New England Council, which deserves, I think, enormous credit for having advanced this issue as well.

Last fall, our delegation sent a letter to President Clinton requesting a permanent extension of the research and development tax credit be included in the budget. Research and development is extremely important to corporations, especially those involved in the high technology industries.

Massachusetts has the fifth highest spending on research and development in the Nation. Massachusetts is well represented at this hearing today, and you will learn from our distinguished witnesses how important research and development is to the Commonwealth of Massachusetts.

In 1981 President Reagan signed into law a 4-year R&D tax credit to help stimulate the growth and competitiveness of our technology-based economy. This program was highly successful. One dollar of R&D credit stimulates approximately one additional

dollar of private research and development spending over the short term and as much as $2 of extra R&D in the long term. Research and development investment supports thousands of highly skilled employees in some of our growth industries.

Unfortunately, the benefits of the R&D credit have been hampered by the credit's temporary nature and uncertain future. Corporations have not been able to rely on the credit and plan for long-term investment. I believe our Tax Code should provide taxpayers with certainty.

U.S.-based R&D is critical to our continued economic growth. The R&D credit provides a significant incentive for U.S. companies to perform R&D in the United States, providing high-skilled, high-paid jobs for American workers.

This credit requires companies to increase their current R&D spending above a predetermined base before they are eligible to receive the credit. Since 1981 the credit has been extended five times and changed to reduce the benefits available to certain companies. Failure to make the credit permanent has substantially reduced its value to businesses. Corporate research planners cannot rely on the incentive provided by the R&D tax credit if it is extended for 12 to 18 months at a time.

Foreign governments are competing fiercely for U.S. research investments by offering tax and other financial incentives. We can no longer assume American companies will automatically choose to site their R&D operation in the United States. A permanent and robust U.S. R&D tax credit is essential to help ensure U.S. companies keep the majority of their R&D function and R&D jobs in the United States.

New England would substantially benefit from a permanent R&D credit. New England is still trying to recover from difficult economic times. A permanent R&D credit would provide a significant incentive for New England companies to perform research and development in New England. The technological innovations perfected through research and development are necessary to assist New England companies that are undergoing defense conversion to compete in the marketplace.

The first step is to make the R&D credit permanent. I know that some of us would like to see these changes made. However, providing taxpayers certainty should be our first goal.

I look forward to hearing additional testimony over the next few days and want to thank you personally for the efforts that you have extended on behalf of the R&D credit.

Chairman JOHNSON. Thank you, Mr. Neal.

You are absolutely right about how important this is to New England. It is interesting that the first two Members are from opposite ends of the Nation; it shows how very important this is.

Mr. Meehan.

STATEMENT OF HON. MARTIN T. MEEHAN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MASSACHUSETTS

Mr. MEEHAN. Thank you, Madam Chairwoman, members of the subcommittee. I have been working on this issue as a cochair of the Manufacturing Task Force, which is part of the Northeast-Midwest Congressional Coalition, and we had hearings around the country.

I had no idea about Elvis' support for this, and I am glad that Congressman Neal has brought that forward.

I am pleased to offer testimony on the need to extend and improve the research and experimentation tax credit now contained in section 41 of the Internal Revenue Code.

Since the Great Depression, between 65 and 80 percent of all productivity improvements can be attributed to the use of new technology. Some studies have shown that for every $1 that an individual business realizes from the investment in R&E, society as a whole realizes $2, $3, or even more dollars.

Research plays a critical role in the competitive status of the United States. It is a downpayment on future economic vitality. Without adequate R&E, our businesses will eventually lose the race for discoveries and innovations that form the basis for new products, new services, new manufacturing processes, market share, and ultimately, world influence.

Ultimately, the United States share of R&E has fallen for the first time in 20 years, and more research is being conducted overseas by U.S. companies. As cochair of the Northeast-Midwest Congressional Coalition on Manufacturing, I hosted hearings throughout the Northeast and Midwest during the 103d Congress and had numerous meetings with manufacturers, economic development offices, economists throughout the country, to talk to them about the types of policies that would help small and medium-sized manufacturers survive and prosper. Based on these discussions, the Task Force identified the R&E tax credit as a key contributor to U.S. manufacturing success.

We also determined that its potential could be significantly enhanced if a few key modifications were adopted: First, make the research and experimentation tax credit permanent; and second, extend it to cooperative research.

A permanent R&E credit would give companies more fiscal certainty to plan for long-term expenditures and to discover and develop new products and technologies. Moreover, extending the credit to cooperative research with institutions, such as Federal labs, working with universities, would greatly encourage joint ventures in research and experimentation. The advantage of such ventures is that they would spread the risk of research, making companies more willing and able to undertake activities leading to product and process innovation.

Technology is a driving factor in enhancing productivity and prosperity. A permanent and extended R&E tax credit is essential to continue the business and employment growth that has again begun to develop in our region and my home State of Massachusetts.

Technology development is particularly critical to the firms in the Northeast. The region's high cost of living requires manufacturing firms to pay higher wages. These higher wages can only be sustained through high-value-added manufacturing that comes from research and development.

When American technology and manufacturing ruled the world, we had no need to examine how technology was produced or how it was disseminated throughout our manufacturing base. We must now carefully examine the means by which this technology, instead

of merely developed in the United States, is deployed and actually used by our small and medium-sized manufacturing base. We must work together to fashion the right mechanism whereby technology can be developed and transferred in the most economically efficient manner.

The proposed modifications will improve the credit in a fiscally responsible way. By stimulating industry-led collaborative efforts, the modified credit will maximize limited private and public sector R&E funds, and it will encourage firms to better allocate scarce research resources to projects that advance both their individual and collective goals. Throughout the Tax Code, we can construct the framework for research partnerships that are truly industry led in the most efficient manner possible.

I encourage the subcommittee to enact this important improvement to the R&E tax credit when it is considered in the coming weeks. Thank you very much. My compliments to you for having this hearing.

[The prepared statements follow:]

STATEMENT OF REP. MARTY MEEHAN AND BOB FRANKS
CO-CHAIRS OF NORTHEAST-MIDWEST CONGRESSIONAL COALITION
CO-CHAIRS OF THE NATIONAL TASK FORCE ON MANUFACTURING

Dear Madam Chairman and Members of the Subcommittee on Oversight: We are pleased to offer testimony on a matter of great importance to states in the Northeast-Midwest region and across the nation that rely on the jobs and economic activity that a healthy manufacturing base provides—the need to extend and improve the research and experimentation tax credit now contained in Section 41 of the Internal Revenue Code.

In our capacities as co-chairs of the Northeast-Midwest Congressional Coalition and the National Task Force on Manufacturing, we examined the need for a permanent and improved R&E tax credit as part of a larger assessment of tax and finance alternatives aimed at strengthening the nation's manufacturing sector. Since the Task Force was launched early in the 103rd Congress, we have heard from manufacturers and policy experts during forums we convened in Washington and around the region. During these sessions, we discussed at length manufacturing finance needs and incentives with experts such as former Senator Paul Tsongas and George Hatsopoulos, CEO of ThermoElectron in Waltham, Massachusetts, who emphasized the need for a permanent and predictable R&E tax credit. Numerous economists, economic development officers, and small and mid-sized manufacturers themselves were consulted about the types of policies that would help them survive and prosper.

Through the extensive efforts of Task Force members—such as Congresswoman Johnson—we identified the R&E tax credit as a key contributor; we also determined that its potential could be significantly enhanced if a couple of key modifications were adopted. Based on this analysis, we included the following as the fourth recommendation in the Task Force report, ***Getting Back to Work: Breathing New Life into American Manufacturing:***

> *"Make the research and experimentation tax credit permanent and extend it to cooperative research."*

We believe that such an action is important to manufacturing and important to the economy of our region. A permanent R&E credit would give companies more fiscal certainty to plan for long-term expenditures and to discover and develop new products and new technologies. Moreover, extending the credit to cooperative research with institutions such as federal labs (or universities working with the labs) would encourage a greater number of joint ventures in research and experimentation; the advantage of such ventures is that they would spread the risk of research and make companies more willing and able to undertake activities leading to product and process innovation.

As the Task Force report noted, technology—rather than labor cost—is the driving factor in enhancing productivity and prosperity. A permanent and extended R&E tax credit is essential to continue the business and employment growth that has again begun to blossom in our region. Technology development is particularly critical to firms in the Northeast. The region's high costs of living require manufacturing firms to pay higher wages. These higher wages can only be sustained through high value-added manufacturing that come from research and development. The R&E tax credit being discussed today by the committee is one of the best vehicles to encouraging this important research and development.

To further increase the benefits of a permanent R&E credit, we believe the committee should consider extending the R&E tax credit to collaborative research. We would like to submit more detailed analysis for the record on this point. Essentially, bringing together firms with similar interests and needs, federal labs, and universities could provide the catalyst for innovation and creativity that could lead to widespread economic growth. Other nations have developed and nurtured highly successful technology development and deployment mechanisms based on such collaboration, and we in the United States must begin to promote this type of environment.

In closing, Chairwoman Johnson, we urge the Committee to make the credit permanent and to increase the incentive for collaborative R&E efforts. In this way, the greatest potential can be garnered from private and public research efforts, and the manufacturers of this country can begin to regain their competitive advantage.

THE BENEFITS OF A PERMANENT, EXTENDED R&E TAX CREDIT

1. R&E Is Essential to Our National Competitiveness

Real economic growth always has been dependent on development and application of new science, innovation, and technology. Since the Great Depression, between 65 and 80 percent of all productivity improvements have been attributable to the use of new technology. Indeed, studies have shown that for every $1 dollar that individual businesses realize from their investment in R&E, society as a whole realizes $3 or more. High technology firms alone represent a significant importance to our nation. As indicated in the recent OSTP study, while high technology firms comprised only 0.7 percent of all U.S. firms (excluding sole proprietorships), their importance to the national economy far outstrips their numbers. They are the source of a disproportionately large share of employment, sales, and export growth. And they are the source of innovation from which flow much of the improvements in our nation's standard of living.

Not surprisingly, therefore, research plays a critical role in the competitive status of the U.S. It is a down payment on future economic vitality. Without adequate R&E, our businesses will eventually lose the race for discoveries and innovations that form the basis for new products, new services, new manufacturing processes, market share and ultimately, world influence.

Unfortunately, the U.S. share of R&E has fallen for the first time in 20 years, and more research is being conducted overseas by U.S. companies. Moreover, when our industries do make the necessary outlays, the commercialization of new technology and its assimilation into the manufacturing process are being accomplished more swiftly by our competitors. According to the National Science Board:

- *U.S. R&E stagnated in the late 1980s and continues to stagnate into the 1990s, showing a growth rate of only 0.4 percent, as foreign rivals increase their R&E investments.*
- *U.S. spends too few dollars on industrial R&E and makes poor use of the ones it does spend.*
- *Corporate laboratories are under severe financial stress and being forced to shift to shorter-term R&E.*

2. More Collaborative R&E on Manufacturing Process and Other R&E Must be Encouraged

There is little doubt that the current R&E credit stimulates product innovation and improvements to existing products. Accelerating advances in product design and manufacturing technology have re-shaped the manufacturing environment and the global marketplace for goods. Manufacturing firms are coping to adjust to a new environment where production runs are shorter, product cycles are quicker, and failure-free and timely production at decreasing costs is a condition for survival. The effects of these dramatic changes are intensified as an increasing number of smaller industrial firms enter the economic landscape with fewer workers with greater skill demands.

In this arena, process technology plays an increasingly prominent role. Access to and adoption of new technologies can outweigh transportation and labor considerations. Small and medium-sized manufacturers are particularly at risk due to limited technical and financial resources for acquiring and implementing off-the-shelf productivity tools.

Moreover, mere investment in new technologies may not be enough to address the challenge of international competition for domestic and international markets. U.S. companies also must benefit from instituting a continuous improvement process based on first upgrading their technologies and training. All companies must develop new expertise and integrate it with the traditional skills in order to modernize their factories with various advanced manufacturing techniques. Frequently, small companies that invest in new technology cannot afford the additional engineering talent required to organize their operations in ways that fully exploit the technologies they have adopted.

The ability to adapt to technological change is also an increasing requirement along the manufacturing food chain. Large companies, foreign and domestic, are becoming more concerned about their supplier's technological and organizational abilities. Manufacturers along the supply chain feel these competitive pressures manifested in the form of requirements for better quality, greater reliability, and more timely delivery. However, the small supplier usually cannot meet these demands without investing in new technologies. Without such investments they are operating far below their potential — their methodologies and management practices are inadequate to ensure that American manufacturing will be globally competitive.

3. *Collaborative R&E is Done To a Greater Extent in Foreign Nations*

The problem is exacerbated by the increasing tendency of foreign competitors to engage in collaborative R&E. Our foreign competitors have increased their investment in research, often acting in teams that leverage their investments. In the U.S. today, approximately 200 industry consortia have been established under the 1984 Act, and new groups are forming as companies band together to face stiff global competition. However, this represents a small amount of the R&E pool. Little over 1 percent of all research is conducted cooperatively. Of the $150 billion in research and development conducted in the United States, only approximately $2 billion is conducted by consortia.[1]

By contrast, more than four times the relative percentage of R&E conducted cooperatively in Japan is collaborative, and about one-fifth of all joint research (or 6 percent of total R&E) is "horizontal" collaboration — collaboration among competing firms. Collaborative European projects include ESPRIT in information technology, RACE in advanced communications, BRITE in advanced materials and manufacturing, VLSIC for high capacity memory chips, ICOT for the fifth generation computer, and TRC for joint research on magnetic levitation and other technologies.

The U.S. must do more to promote cooperative research if we are to keep pace with our principal trading partners.

4. *The Collaborative Credit Will Benefit Firms Not Encouraged by the Current Incremental Credit*

The proposed enhancement to the R&E tax credit will promote cooperative research. The cooperative credit will assist companies that are otherwise increasing their R&E expenditures above the "base," regardless of how that base is defined in the section 41 incremental credit. Equally important, however, it also will benefit companies that cannot take immediate advantage of the incremental credit either because they do not have taxable income against which the credit can be offset, are subject to the limitations of the Alternative Minimum Tax, or whose R&E falls below the base. It also includes smaller firms that may be disinclined to invest the needed amounts in process or other technologies not perceived to inure to the bottom line immediately but need to make the investment to remain competitive in the long-run.

The ability to share in the results of cooperative research that is "incentivized" or encouraged by the enhanced credit is a direct benefit to all participants in a cooperative venture. In essence, the leveraged research is disseminated to small and large firms alike, both profitable and currently unprofitable firms, and the indirect benefit of the credit is spread to the entire membership of the project. For firms that are below the "base," cooperation will allow them to "catch up to the fold" with immediately rewardable R&E expenditures.

The National Academy of Engineering also endorsed the idea of a collaborative R&E tax credit. Specifically, a recent Academy Study Commission, looking at various measures to increase the level of stability of R&E tax policy, recommended that the U.S.:

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[1] According to a recent survey Alliance for Collaborative Research, companies conduct research and development with consortia for four major reasons: (1) to reduce the cost of conducting research by spreading the cost, (2) to reduce the risk of conducting high-tech research in untried areas, (3) to reduce redundant research within an industry -- for example, innovations needed to meet an industry-wide standard or solve a broad problem, and (4) to conduct research which will only benefit the firm after a long period. Much of this research would not be conducted without the umbrella of the consortia because of the factors above -- risk, costs, and few short term benefits.

- 35% of consortia research reduces redundancies.
- 30% of consortia research spreads risks.
- 20% of consortia research spreads costs.
- 15% of consortia research will benefit only in the long term.

replace the current incremental Research and Experimentation tax credit with a permanent tax credit on the total annual R&E expenditure of a company to encourage an increase in the level and the stability of R&E activity across business cycles. In addition, extend the R&E tax credit to cover industry-sponsored R&E in universities, and other institutions, and the industrial contribution to R&E performed as a part of a consortium that includes government laboratories.

As the committee is actively considering changes that would reward collaborative R&E — similar to the changes contained in S. 666 introduced last Congress by Senators Danforth and Baucus — I would like to focus my comments on the credit as it relates to collaborative R&E.

5. Collaboration Encourages New R&E, which is the Purpose of the R&E Tax Credit

Collaboration in areas of engineering research, for example, often concentrates on R&E that is not being performed by the private sector on an individual firm level. For example, much collaborative R&E focuses on unit manufacturing process R&E, which has been recognized by the National Research Council as grossly underfunded at a national level. While manufacturing process R&E can significantly improve the quality of products, lower costs, reduce scrap and improve the environmental integrity of manufacturing processes, it is difficult for any single manufacturer to capture the benefits of such research as opposed to the benefits of product-specific R&E. However, over the longer term such research has long range effects on our National industrial base and our National security.

Encouraging research that would not otherwise be conducted, as the Subcommittee knows, is the underlying justification of the R&E tax credit. Stimulating a change that would enhance and encourage collaboration would greatly advance the underlying policy goals of the current law, while incorporating sound science and engineering policy considerations.

6. Collaboration Also Reduces Duplication

Changes that would accelerate growth of collaborative enterprises is one of most important steps that can be taken to stimulate R&E in our tax code. Of course, when such a modification does not stimulate new R&E, it ensures R&E will be conducted through consortia for an altogether different reason. Much of the research being performed on process or environmental technology could be streamlined through consortia, which typically provide a more efficient vehicle for R&E activity. This consideration is highly important during a period when, as the National Science Foundation points out, our private and public R&E resources are increasingly limited, and we have reduced the level of R&E as a function of GDP for the first time in more than 20 years.

7. Collaboration Assists in Technology Deployment

Finally, apart from reducing duplication of research or stimulating new R&E, consortia provide a fertile and robust environment for the deployment of technology, once developed. The consortia environment combines both suppliers and users of process R&E so the widest market for the implementation of such technology is assured.

Technology deployment is the means by which advanced manufacturing technologies, either equipment, software, processes or management techniques, find their way from development to the factory floor. Sustained, expeditious, and effective technology deployment is essential to help our manufacturing sector generate desperately needed economic development.

Beyond generalizations, the slow rate at which new technology is adopted in the U.S. is a demonstrable barrier to the deployment of new inventions and concepts into manufacturing industries. U.S. industry experts state that approximately 90 percent of new discoveries require 25 to 75 years to achieve widespread implementation in the U.S. The mean implementation time is approximately 55 years. By comparison, many of our trading partners bring new technology to fruition in much shorter time frames. This comparison is particularly salient when examining the Japanese, who claim a 400 percent faster adoption rate than the U.S. in R&E and automation.

The Committee must keep in mind that the final goal of the R&E tax credit is not merely to stimulate new R&E spending, but to commercialize or deploy technology that results from that spending.

Conclusion

When American technology and manufacturing ruled the world, we had no need to examine how technology was produced or how it was disseminated throughout our manufacturing base. We must now carefully examine the means by which this technology, instead of merely being developed in the U.S., is deployed and actually used by our small and medium-sized manufacturing base. We must look towards encouraging process R&E as opposed to simply product R&E. We must work together to fashion the right mechanism whereby technology can be developed and transferred in the most economically efficient manner. I believe a collaborative tax credit modification to existing law is a cost-effective means to achieve this objective.

The proposed modifications will improve the credit in a fiscally responsible way. By stimulating industry-led collaborative efforts, the modification credit will maximize limited private and public sector R&E funds, and it will encourage firms to better allocate scarce research resources to projects that advance both their individual and collective goals. The modification will also stimulate new research — research unlikely to be undertaken individually because it is too costly, too risky, or too long-term. Finally, by making efficient use of public and private R&E resources, the modification will fully and cost-effectively advance the main policy rationale behind the existing credit.

In today's world, maintaining latest technology is not just a question of market share, it is a question of survival. In technology-intensive industries, failure to keep up with technological advances will have immediate repercussions, not only for the firms involved, but for the entire U.S. industry. Through the tax code we can construct the framework for research partnerships that are truly industry-led in the most efficient manner possible. I encourage the Committee to enact this important improvement to the R&E tax credit when it considers the credit in the coming weeks.

Chairman JOHNSON. Thank you very much for your testimony.

This has certainly been all along a very bipartisan issue; it has been Matsui-Johnson, it has been Johnson-Matsui. We intend to work very closely on it.

I appreciate your bringing our attention to the issue of team research, and particularly as we look at the goal of a balanced budget, one of the things that does come to mind is the inefficiency of government trying to support certain kinds of research that really does need to be done, and it may be possible to use some of that money to fund a credit that would help the private sector work more creatively on some of the difficult projects that we know need to move forward.

That is by way of saying that everything that we do is going to have to be paid for; but it is also true that this law was written, now, almost 15 years ago. Companies have changed dramatically, the economy has changed dramatically; and I urge you to share with us thoughts you have about how it ought to be modernized, because we are going to look at that, we are going to cost them out, and we are going to see what are our options in terms of making this a more powerful actor in our economy for all the reasons that you so eloquently set forth in your testimony.

I thank you for your good words, your support, and your thought in this area, and look forward to working with you.

I yield to my colleague, Mr. Matsui.

Mr. MATSUI. Thank you, Madam Chair. I don't have any questions for the three witnesses. I appreciate all of their testimony, particularly Anna Eshoo who is a colleague of mine from California, who is involved with the accounting changes for the incentive stock options and helped, obviously, the high technology industry in California and nationally there. I appreciate that very much.

Of course to Rich Neal, a colleague on the committee, who undoubtedly will be very involved in this, and Marty Meehan. We want to thank all of you for your testimony today, and we look forward to working with all three of you. Thank you.

Chairman JOHNSON. Mr. Ramstad.

Mr. RAMSTAD. Thank you, Madam Chair. I would like to associate myself with the remarks of the distinguished chairwoman, as well as the ranking member of the subcommittee. I also want to thank the three witnesses for being here today. It is refreshing to work together in a bipartisan, pragmatic way on something.

If there is anything we can agree on, it is certainly the extension of this important tax credit. As one who, like the three of you, represents a high technology district, certainly 300—and my good friend and cochair of the House Medical Technology Caucus might disagree, but I think 300 of at least the finest medical technology and biotechnology firms in the world, we recognize the importance of this credit. I don't think there is anywhere else in the Federal budget that we get as much bang for our buck.

We are talking about spending, over the 6 years, given a permanent extension of R&D, of the R&D tax credit, about $8 billion—$1.1 billion this year, going up to a little over $2 billion in the year 2000.

I would like to ask if you know of any studies as far as the macroeconomic—we all know in our respective districts, high tech-

nology districts but as far as the macroeconomic effects, in terms of job creation, capital formation, what we are talking about? What does it mean, $1 returned for every $1 of tax credit?

I mean, for example, when we look at capital gains, we know—we had economist after economist come to our subcommittee, and Alan Sinai sat there and told us that the macroeconomic effect of reducing capital gains tax rates would be to create about 1.4 million new jobs over the 5 years.

Perhaps we should wait until more technical witnesses come before the subcommittee.

Mr. NEAL of Massachusetts. Mr. Ramstad, I would just offer kind of an anecdote on that.

In Massachusetts, the link between our public and private university system and, I think, the growth of the high technology industry is substantial evidence as to how these events play out. I clearly think that as we take up in this subcommittee, over the next few weeks, budget deliberations and discussions, we will have a chance to crystallize some of those issues as we determine what ought to remain and what ought to go.

But I think that I cannot emphasize enough how important this has been to our university system across the State, which has a reputation, I think most would agree, that is second to none in the country. The link between those institutions and the growth of the high technology industry offers substantial evidence in support of extending this credit permanently.

Ms. ESHOO. I was just going to add, Representative Ramstad—and thank you for your nice comments—to underscore what I had stated in my testimony, that demonstrates the extraordinary growth from 1972 to 1992 for computer and software technology companies which was approximately 27 percent—this is over nine times the growth rate of the national economy during that period.

I know that you are asking specifically for something else, and I believe in the following panel you will hear testimony taken from a study that was conducted that will, in my view, directly underscore or answer the question that you have directed to us.

Thank you anyway.

Mr. MEEHAN. I headed a study that had a 3-to-1 ratio in terms of the investment that would result.

I would point out that my emphasis here is on manufacturing jobs. I believe that manufacturing is the engine that drives the economy, and our ability to produce products and to have more people working in manufacturing is critical because of the spinoff and multiplier effect of manufacturing jobs in general. So I think it is significant.

With regard to the budget issues, having supported, myself, a balanced budget, I feel it is very important that when we make determinations about where we can cut taxes—and personally, I believe there are very, very small instances where we can—this should be a priority. We should provide the $8 to $9 billion in cuts up front to pay for it. Ultimately, as we get to a balanced budget, we will all have some very, very difficult choices to make.

I don't believe the country can afford very much in terms of tax cuts. This is one of the tax incentives that we have to find the cuts for and make it work, because it is critical.

Mr. RAMSTAD. Well, thank you again, Madam Chair.

I certainly agree with all three of you. I look forward to working together with you for enactment of a permanent R&D tax credit.

Thank you, Madam Chairman.

Chairman JOHNSON. Thank you very much.

Thank you for your interest in this. We will be looking at options, so as you think about those things, don't hesitate to bring them forward. We will also be looking at a flat credit versus the structure in the current law. We will also be looking at how to pay for it, and one of the ways to look at that is, are there other portions of the tax system we impose on business that are less important, that are less significant in terms of rewarding the kind of behavior that is going to keep us a cutting-edge nation in 10 years. So all of that is on the table, and your thoughts will be welcomed.

Thank you for your testimony.

The next panel will be Mr. Gandhi, the associate director of Tax Policy and Administration for the U.S. General Accounting Office; Christopher Anderson, the general counsel, Massachusetts High Technology Council in Massachusetts; Michael Hooker, president of the University of Massachusetts on behalf of The New England Council; Doug Olesen, president and chief executive officer of Battelle Memorial Institute in Columbus; and Judith Pensabene, director of Federal Affairs and Counsel for Baltimore Gas & Electric Co.

At this moment, I am going to yield to my colleague, Mr. Portman, for purposes of an introduction.

Mr. PORTMAN. I thank the Chairwoman. I just wanted to make a special introduction of a fellow Ohioan. Doug Olesen is president and chief executive officer of the Battelle Memorial Institute in Columbus, Ohio, which is now, I believe, Dr. Olesen, the world's largest contract research organization with offices all around the country—laboratories all around the country—but, again, headquartered in Columbus, Ohio.

Dr. Olesen has also been very involved in the community, Columbus, and statewide. I want to commend him for that and welcome him today.

Thank you, Madam Chairwoman.

Chairman JOHNSON. We will start with Mr. Gandhi.

STATEMENT OF NATWAR M. GANDHI, PH.D., ASSOCIATE DIRECTOR, TAX POLICY AND ADMINISTRATION ISSUES, GENERAL GOVERNMENT DIVISION, U.S. GENERAL ACCOUNTING OFFICE

Mr. GANDHI. Thank you, Madam Chairman.

Madam Chairman, Mr. Matsui, and members of the subcommittee, we are pleased to be here today to discuss several issues we believe are important to your deliberations on the research tax credit.

Congress created the credit in 1981 on a temporary basis to enhance the competitive position of the United States in the world economy by encouraging the business community to do more research. The credit applies to qualified research spending that exceeds a base amount. Currently, the rate of credit is 20 percent of the spending.

On the basis of our past work and newly available data, we have four major observations to make. First, the research tax credit is primarily earned by large corporations in the manufacturing sector. For example, in tax year 1992, corporations earned almost $1.6 billion of credits. Most of these credits, some 71 percent, were earned by corporations with assets in excess of $250 million. Within the manufacturing sector, which earned 76 percent of the credit, the four industries that earned the most credits were chemicals, including drugs, electronic, and nonelectronic machinery, and motor vehicles.

The amount of the credit earned is not equivalent to the revenue cost of the credit because not all of the credit earned can be used immediately. The Joint Committee on Taxation has estimated that if the credit were extended, its annual revenue cost would be approximately $2.2 billion by fiscal year 1998.

Our second observation is that the research credit is basically a transfer of money from all taxpayers to those taxpayers who exceed the base research spending. This transfer is to induce changes in the productive activities within the economy. It is commonly held that society generally benefits more from R&D spending than from nonresearch spending, but data to measure such benefits are very limited, making it difficult to determine conclusively whether the research tax credit provides a net benefit to society.

Now, the third observation. Congress in 1989 revised the rules for calculating the base. Before 1989 the base was calculated in such a way that a link was established between current spending and future base amounts. The link substantially reduced the credit that was available in the future years. In an earlier study, we estimated that, at the margin, the credit at the time provided companies a benefit of 3 to 5 cents per $1 of additional research spending. We further estimated that each $1 of taxes forgone stimulated between 15 and 36 cents of research spending. Although the amount of research spending stimulated by the credit was well below the credit's revenue cost, total benefits could have been much higher.

The 1989 revision broke the link between the current spending and the future base by creating a fixed base, as opposed to the moving average base that existed before. This revision should have increased the amount of research spending stimulated by the credit.

At the same time, available evidence suggests that the fixed base of the credit has become too generous for some corporations in the sense that a large portion of the credit they receive is for spending they would have done anyway. On the other hand, some other corporations are unable to earn any credit, resulting in less overall research being stimulated.

If the credit is extended in its current form, Congress may want to provide for reviewing and adjusting this base as needed.

Our last observation is that the research credit has been difficult for IRS to administer. This conclusion was based on a survey of IRS revenue agents who audited large companies. These agents questioned the credit claimed by 79 percent of the corporations in which the credit was audited, and 54 percent of the agents found at least one aspect of the credit difficult to audit.

About one-fifth of the agents said the definition of "qualified research" was unclear. In 1994 the Treasury Department issued final regulations that may resolve this uncertainty. However, IRS confirms we still have to distinguish innovative research from routine research. That is because innovative research qualifies for the credit; routine research does not.

In conclusion, Madam Chairman, given the lack of empirical evidence for evaluating the credit's net benefits to society, we have not taken a position as to whether the research credit should be made permanent or allowed to expire.

We have, however, concluded that if the Congress decides to extend the credit, it may also want to ensure that the credit provides an attractive incentive to most recipients at an acceptable revenue cost. One way this could be done is by requiring that the base be reviewed and adjusted as needed.

That concludes my oral statement, Madam Chairman. I request that my written statement be placed in the record. I welcome any questions that you and the other Members may have. Thank you.

[The prepared statement follows. Due to its size, Objectives, Scope, and Methodology, Appendix I, is being retained in committee files.]

ADDITIONAL INFORMATION ON THE
RESEARCH TAX CREDIT

SUMMARY STATEMENT OF
NATWAR M. GANDHI
ASSOCIATE DIRECTOR, TAX POLICY AND ADMINISTRATION ISSUES
GENERAL GOVERNMENT DIVISION
U.S. GENERAL ACCOUNTING OFFICE

Madam Chairman and Members of the Subcommittee:

We are pleased to be here today to provide information on the research tax credit and to discuss several issues that we believe are important to your deliberations on the future of the credit.

In 1981, Congress created the research tax credit to encourage business to do more research. It believed that an increase in research was necessary to enhance the overall competitive position of the U.S. economy. Since its enactment on a temporary basis in 1981, the credit has been extended six times and modified four times. The credit has always been incremental in nature. Taxpayers are to receive a credit only for qualified research spending that exceeds a base amount. The current rate of credit is 20 percent of that incremental amount of spending.

On the basis of our past work[1] and newly available data, we have the following four major observations to offer:

-- The research credit is primarily earned by large corporations in the manufacturing sector.

-- The credit's net benefit to society would ideally be evaluated in terms of the ultimate benefits derived from the additional research that it stimulates and not just on the basis of how much research spending it stimulates for a given revenue cost. However, once the decision has been made to provide some form of credit, the amount of spending stimulated per dollar of revenue cost is a relevant criterion for assessing alternative designs for the credit.

-- The revisions that Congress made in 1989 should have increased the amount of research spending stimulated per dollar of revenue cost. However, available evidence suggests that the fixed base of the credit has become too generous for some corporations, in the sense that a large portion of the credit they receive is for spending they probably would have done anyway. At the same time other corporations are unable to earn any credit, resulting in less overall research being stimulated. If the credit is extended in its present form, Congress may want to provide for reviewing and adjusting this base as needed.

-- The research credit has been difficult for the Internal Revenue Service (IRS) to administer, primarily because the definition of qualified research spending was unclear. In 1994, the Treasury Department issued final regulations that may resolve this uncertainty. However, IRS and firms will still have to distinguish innovative from routine research.

Now I will elaborate on each of these points.

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[1]Preliminary Analysis of the Research and Experimentation Tax Credit (GAO/GGD-88-98BR, June 1988); The Research Credit has Stimulated Some Additional Research Spending (GAO/GGD-89-114, Sep. 1989); Pharmaceutical Industry's Use of the Research Tax Credit (GAO/GGD-94-139, May 1994); Information on the Research Tax Credit (GAO/T-GGD-95-140, April 1995). The objectives, scope and methodology of this testimony are discussed in appendix I.

CORPORATIONS USING THE RESEARCH CREDIT

In tax year 1992, corporations earned almost $1.6 billion worth of research credits.[2] Most was earned by large corporations in the manufacturing sector--71 percent by corporations with assets in excess of $250 million and 76 percent by manufacturing corporations. Within the manufacturing sector, the four subsectors that earned the most credits were those producing chemicals (including drugs), electrical equipment, motor vehicles, and nonelectronic machinery. (See Tables 1 and 2 for more details.)

The amount of credit earned is not equivalent to the revenue cost of the credit because not all of the credits earned can be used immediately. The general business credit limits the use of the research credit by combining it with other credits for the purpose of computing an overall limit on the reduction of a company's tax liability.[3] Although corporations earned almost $1.6 billion of research credits and had other general business credits totaling $4.5 billion (including carryforwards from prior years), they were able to use only $1.1 billion of general business credits against 1992 tax liabilities. The Joint Committee on Taxation has estimated that, if the credit were extended, by fiscal year 1998, its revenue cost would be approximately $2.2 billion per year.

EVALUATING THE CREDIT

The research credit is basically a transfer of money from all taxpayers to those taxpayers who exceed their base research spending. This transfer is meant to induce changes in the productive activities within the economy. It is commonly held that society benefits more from research and development spending than from nonresearch spending. But data to measure such benefits are very limited.

If the activities encouraged by the credit are, in fact, more beneficial to society than activities discouraged by this reallocation of resources, then the credit would be considered sound tax policy. We know of no studies that show whether the credit is better than alternative forms of government incentives aimed at encouraging research. We do know that the more research spending the credit stimulates per dollar of revenue cost, the better the credit would compare to other policies.

As we explain in the next section, the base calculation for the credit has an important effect on the incentive provided for increased research spending. Other factors also affect the incentive. These include the rate at which research expenses reduce tax liability, limits on the amount of general business credits that may be claimed, reductions in research expense deductions by the amount of credit claimed, and the carryover provisions for companies without sufficient tax liability to claim the credit. These factors, which affect individual

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[2]These data were extracted from the IRS' Statistics of Income and exclude credits earned by individuals and partnerships. The data include S corporations, which represented about 30 percent of the corporations earning a credit but accounted for only 2.4 percent of qualified spending and 4.1 percent of the credit earned.

[3]The general business credit includes such tax credits as the targeted jobs credit and the low income housing credit. Research credits accounted for about 86 percent of the current year general business credits of companies earning a research credit in 1992. The general business credit cannot exceed net income tax minus the greater of (1) the tentative alternative minimum tax or (2) 25 percent of the net regular tax liability above $25,000.

companies differently, are important in determining the incentive for increased research spending provided by the credit. For example, in 1992 about 79 percent of the corporations earning research credits had accumulated more general business credits than they could use. This meant that additional research credits earned by these corporations could not be used against current tax liabilities, thus reducing the marginal incentive provided by the credit.

ISSUES RELATING TO THE BASE OF THE CREDIT

The rules for determining the base spending amount to be used when calculating the credit have a critical impact on the credit's effect.[4]

To stimulate the most research spending per dollar of tax revenue forgone, the credit should be designed to give a benefit for research spending that firms undertake above and beyond the amount they would have spent in the absence of the credit. Conversely, no reward should be given for research that firms would have undertaken anyway. Unfortunately, it is impossible to determine accurately the amount of qualified research that firms would have undertaken without the credit. When discrepancies exist between this "ideal" base for the credit and whatever base is used in practice, the result is that firms are rewarded either too much or not enough for their spending behavior.

Prior to 1990, the base of the regular credit was equal to the average of qualified expenditures for the 3 previous tax years or to 50 percent of the current year's expenditures, whichever was greater. Although this base may have been a fairly good approximation of the ideal base, it had a serious flaw. The moving average base established a link between the taxpayer's current spending and future base amounts in a manner that substantially reduced the incentive provided to many companies. Specifically, each dollar spent in any year raised the base by 33 cents in each of the next 3 years, thus reducing the credit available in those years.

In our 1989 study, we estimated that, at the margin, the previous credit provided companies a benefit of 3 to 5 cents per dollar of additional research spending. We further estimated that this incentive stimulated between $1 billion and $2.5 billion of additional research spending between 1981 and 1985 at a cost of $7 billion in tax revenues. Thus, each dollar of taxes forgone stimulated between 15 and 36 cents of research spending. Although the amount of research spending stimulated by the credit was well below the credit's revenue cost, total benefits could have been much higher.

The revision of the credit in 1989 significantly increased the effective incentive of the regular credit by breaking the link between current spending and future base amounts. For most credit recipients, this new base is related to the ratio of research spending to gross receipts during the period 1984

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[4]Corporations can receive credits three different ways. First, they can earn credits for undertaking research themselves. For convenience, we will refer to this as the "regular" credit. Corporations can also earn credits for funding basic research by qualified organizations (primarily universities). This basic research credit accounted for less than 2 percent of the total amount of research credit earned in 1992, and the rules for computing this credit are different from those for the regular credit. Finally, corporations can receive flow-through research credits from other taxpayers. Flow-through credits also accounted for less than 2 percent of total research credits in 1992. The remainder of our testimony will focus on the regular research credit.

through 1988. To arrive at the base amount, this ratio or "fixed base percentage," as it is known, is multiplied by the taxpayer's average annual gross receipts for the 4 years preceding the current tax year.

One concern about the current base is that the spending behavior that individual firms exhibited from 1984 through 1988 may not be reflective of the spending that those firms would engage in now if the credit did not exist. The current base is appropriate as long as firms' ratios of spending to gross receipts are fairly constant over time. To the extent that taxpayers change their spending behavior over time, the credit computation would be too generous for some taxpayers, resulting in undue revenue losses. At the same time, it would deny others the opportunity to earn the credit, thus stimulating less overall research. Our analysis of corporate taxpayer data indicates that the accuracy of the credit's base has eroded significantly since 1989, which suggests the need for some adjustment to ensure that the credit provides an attractive incentive at an acceptable revenue cost.

Our analysis shows that the current computation rules are too generous for most corporations that earn the credit, in the sense that a large portion of the credit they receive is for spending they probably would have done anyway. We also found some evidence that many corporations earning the credit prior to the 1989 revision were unable to earn it in 1992.[5]

Our analysis first determined how many corporations' current research spending was at least double their base amounts. Corporations in this situation become subject to a special rule, that resets their base amount equal to half of their current year's spending. Large numbers of corporations being subject to the special rule indicates a problem with the credit's design for two reasons. First, the effective incentive that the credit provides in this situation is cut in half, because each additional dollar a corporation spends raises its base by 50 cents. Second, given that other studies' most optimistic assumptions imply a stimulative effect of no more than 30 percent, it is unlikely that the credit leads corporations to come close to doubling their spending on research. Consequently, a significant portion of the credit earned by corporations whose current research expenditures are far above their bases is earned for spending that they probably would have done anyway.

We have found that, in 1992, almost 60 percent of the corporations that reported some regular research spending on their tax return were subject to the special 50-percent base rule. These corporations accounted for about 19 percent of the regular spending done and 40 percent of the regular credit earned by all corporations reporting spending. Small corporations were much more likely to be in this situation than were large corporations. We have not yet determined the reasons for this. (Table 3 provides additional information on the characteristics of these corporations.)

Our second analysis involved tracking the credit-earning experience of individual corporations from 1989 through 1992. Unfortunately, the database that we were able to construct

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[5]Although our evidence concerning cases where the base is too low is stronger than our evidence concerning the opposite problem, this may simply be due to the fact that the former situation is much easier to detect. Corporations that earn a research credit in a given year report both their current research expenditures and their base amount on IRS form 6765. However, if research spending does not exceed the base amount, no credit will be earned and, therefore, no form will be filed. IRS databases do not contain information on research spending by companies that do not file the form.

included only corporations with assets of at least $50 million, so we can provide no insight into the experiences of smaller companies. The roughly 1,600 corporations that we could examine accounted for about 73 percent of the research credit earned in 1989.

The corporations we studied exhibited a wide variety of credit-earning patterns over the 4-year period, but the percentage of them that earned a credit declined every year between 1989 and 1992. In 1989, 65 percent of these corporations were able to earn a regular credit, but by 1992 less than 54 percent of them could. We do not know how much of this decline can be attributed to the change in the credit's design after 1989, but the pattern does indicate that a growing number of large corporations are not able to surpass their historic rates of spending (see Table 4 for more details.)

ADMINISTRATION OF THE RESEARCH CREDIT

In our earlier work, we concluded that the credit was relatively difficult for IRS to administer. This conclusion was based on our survey of IRS revenue agents who audited large companies for tax years 1981 through 1986. The survey found that these IRS revenue agents questioned the credit claimed by 79 percent of the corporations in which the credit was audited, and that 54 percent of the revenue agents found at least one issue or aspect of the credit difficult to audit. Revenue agents most frequently cited the following four reasons for questioning research expenditures: Rather than for qualifying, innovative research, the expenditures were for (1) adapting existing capabilities, (2) routine or cosmetic alterations, (3) overhead and administration, or (4) ordinary testing. In general, most of these agents found it difficult to distinguish spending for new products or functions from spending that paid for routine or cosmetic changes.

Our interviews with IRS for our 1994 report indicated that this difficulty remained. IRS officials reported that they were required to make difficult technical judgments in their audits concerning whether research was directed to produce truly innovative products or processes. An IRS official stated that, although examination teams often included engineers and other specialists enlisted to address technical issues that arose, IRS still had difficulty matching the technical expertise of the companies' specialists.

In our 1989 survey, about one-fifth of the revenue agents said the definition of qualified research was unclear. One reason cited was the lack of final regulations. The succession of proposed regulations issued in 1983, 1989, and 1993 to define qualified research under section 174 of the tax code created uncertainty about the definition of qualified research and contributed to the difficulty in auditing the research credit. All research spending that qualifies for the credit must first qualify under section 174. In 1994, Treasury issued final regulations that may resolve the uncertainty about the definition of qualified research spending. However, the difficulty of distinguishing innovative from routine research remains.

Audits of the research credit can be burdensome for both IRS and the taxpayer because the audits must determine whether research expenses, such as wages and supply costs, were made in support of research activities that qualify for the credit. The taxpayer is thus required to show that expenses supported qualified research activities. Where detailed project accounting does not exist, both IRS and the taxpayer may find it difficult to separate out after the fact the cost of personnel employed in specific projects. Thus, according to an IRS official, the costs of administering the credit are substantial for both IRS and the taxpayer.

In summary, Madam Chairman, given the lack of empirical information for evaluating the credit's net benefit to society, we have not taken a position as to whether the research credit should be made a permanent part of the tax code or allowed to expire. We have, however, concluded that, if the Congress decides to extend the credit in its current form, it may also want to ensure that the credit provides an attractive incentive to most recipients at an acceptable revenue cost. One way this could be done is by requiring that the base be reviewed and adjusted as needed.

That concludes my summary statement.[6] We welcome any questions that you may have.

[6]This summary statement for the record has been abridged to meet the Committee's formatting requirements. The complete version of the testimony includes information on the history of the credit, more detailed information on industry use of the credit and on corporations subject to the base limitation, and a description of the methodology used to obtain this information. Copies of the complete version, entitled Additional Information on the Research Credit (GAO/T-GGD-95-161), may be ordered by mail from, U.S. General Accounting Office, P.O Box 6015, Gaithersburg, MD 20884-6015. Orders may also be placed by calling (202) 512-6000 or by using fax number (301) 258-4066, or TDD (301) 413-0006.

Table 1 : Number of Corporations Earning Research Credits, Amount of Qualified Spending, and Amount of Credit Earned by Asset Class, 1992

	Corporations earning research credits			Percent of total		
	Number	Qualified spending ($ million)	Credits earned ($ million)	Corporations	Qualified spending	Credits earned
Asset range						
Less than $250,000	1,615	$308	$17	14.8%	0.8%	1.1%
From $250,000 to $1 million	2,377	316	25	21.8	0.8	1.6
$1 million to $10 million	4,144	1,842	129	37.9	4.6	8.2
$10 million to $50 million	1,485	2,025	121	13.6	5.1	7.6
$50 million to $100 million	364	2,865	72	3.3	7.2	4.6
$100 million to $250 million	321	1,683	96	2.9	4.2	6.1
$250 million or more	622	30,719	1,119	5,7	77.3	70.9
Total	10,928	$39,757	$1,580	100.0	100.0	100.0

Note : The numbers are based on sample data and consequently are subject to sampling error. Totals may not equal the sum of the details due to rounding.

Source: GAO analysis of IRS statistics of income data on corporations for tax year 1992.

Table 2 : Percent Distribution of Corporations, Qualified Spending, and Credit Earned by Industrial Sector, 1992.

	Corporations earning research credits		
Industry	Percent of corporations	Percent of qualified spending	Percent of credit
Agriculture	1.2	0.2	0.3
Mining	0.2	0.4	0.2
Construction	0.5	0.1	0.2
Manufacturing	65.3	76.6	75.8
Transportation and public utilities	1.7	8.2	6.2
Wholesale trade	5.6	1.3	2.1
Retail trade	1.3	0.3	0.5
Finance	0.9	0.6	1.1
Services-medical, business	23.3	12.3	13.5
Total all industries	100	100	100

Note : The percentages are based on sample data and consequently, are subject to sampling error. Totals may not equal the sum of the details due to rounding.

Source: GAO analysis of IRS statistics of income data on corporations for tax year 1992.

Table 3: Percentage of Research Corporations Subject to the 50-Percent Base Limit, by Size of Assets, Tax Year 1992

Asset range	Corporations subject to the 50-percent base limitation		
	As a percent of all research corporations in the asset range	Percent share of regular spending done by all research corporations in the asset range	Percent share of regular credit earned by all research corporations in the asset range
Less than $250,000	83.2%	93.6%	97.9%
$250,000 to $1 million	75.5	87.3	94.7
$1 million to $50 million	56.7	64.9	77.3
$10 million to $50 million	41.5	47.7	67.1
$50 million to $100 million	40.5	49.2	68.7
$100 million to $250 million	37.0	40.0	59.9
$250 million or more	27.0	10.4	25.8
All research corporations	59.6	18.8	40.0

Note: These data exclude corporations that reported no "regular" research spending. The numbers are based on sample data and consequently are subject to sampling error. The figures for all research corporations include those for 47 corporations that failed to report valid fixed-base percentages.

Source: GAO analysis of IRS Statistics of Income data on corporations for tax year 1992.

Table 4: Percentage of Corporations in the Panel Able to Earn a Regular Credit Each Year, by Industry, Tax Years 1989 Through 1992

Industry	Number of corporations in the industry	As a percent of all corporations in the panel	Percent of corporations in the industry earning regular credits			
			1989	1990	1991	1992
Agriculture	8	0.5%	87.5%	62.5%	37.5%	37.5%
Mining	28	1.8	53.6	39.3	35.7	35.7
Construction	13	0.8	53.9	38.5	38.5	38.4
Manufacturing	1,080	68.6	69.2	63.4	59.1	57.5
Transportation and public utilities	145	9.2	52.4	43.5	46.9	46.9
Wholesale trade	95	6.0	64.2	61.1	53.7	43.2
Retail trade	31	2.0	45.1	54.8	51.6	48.4
Finance	84	5.3	42.9	28.6	31.0	38.0
Services-medical	90	5.7	66.7	61.1	63.3	54.5
Total all industries	1,575	100.0	a	a	a	a

a. The percentages for all industries were 65.0 in 1989, 58.5 in 1990, 55.5 in 1991, and 53.6 in 1992.

Note: The panel consists of large corporations that (1) were present in the Statistics of Income corporate sample every year from 1989 through 1992 and (2) reported research spending or a research credit in at least one of those years. Totals may not equal the sum of the details due to rounding.

Source: GAO analysis of IRS Statistics of Income data on corporations for tax years 1989 through 1992.

Chairman JOHNSON. Thank you very much, Mr. Gandhi.
Ms. Pensabene.

STATEMENT OF JUDITH K. PENSABENE, DIRECTOR, FEDERAL AFFAIRS AND WASHINGTON COUNSEL, BALTIMORE GAS & ELECTRIC CO., BALTIMORE, MD., ON BEHALF OF ELECTRIC POWER RESEARCH INSTITUTE

Ms. PENSABENE. Good morning, Chairman Johnson, members of the subcommittee. My name is Judy Pensabene, and I am director of Federal Affairs for Baltimore Gas & Electric Co. Prior to my joining the company, I served for 5 years as counsel to the Senate Energy and Natural Resources Committee, where we had oversight for the research and development programs at the Department of Energy.

I appreciate the opportunity to provide testimony on behalf of the member companies of the EPRI, Electric Power Research Institute, regarding the nature of collaborative research and the potential benefits of the specific collaborative R&D tax credit modification as an incentive to promote this highly efficient approach to research and development. I have filed a statement for the record, and I will try to summarize that here so that we can move ahead.

As you examine the existing R&E credit and determine whether you would like to make it permanent, we want to bring to your attention the need for collaborative research that is not specifically addressed in the credit now, and to discuss benefits that would inure if the credit were specifically expanded for that type of research.

We therefore support the inclusion of a 20-percent credit for investment in collaborative research performed by 501(c)(3) not-for-profit scientific and educational organizations as an important part of the R&E credit that you are considering. It would serve as an incentive for the private sector to maintain its commitment to collaborative research.

We are moving toward an era of increasing budget cuts and Federal challenges, funding challenges that are in the offing right now as evidenced by the recent Budget Committee proposal to cut 50 percent out of just one section of the Department of Energy's R&D budget. When we couple that with the competitive arena in which the utility industry is now moving, we are looking at a double hit, if you will, upon our R&D infrastructure in the energy related field.

The technology development programs that are at the Department of Energy are very similar to the type of thing that EPRI does. I would like to talk to you a little bit about EPRI, give you a little background on it, and then proceed to tell you why I think this collaborative research credit would be a very good way to help meet some of these downward pressures on our general R&D infrastructure funding.

EPRI was founded in 1972 by leaders of the electric utility industry in response to a proposal by Congress, at that time occasioned by rolling blackouts in the Northeast United States, to place a mandatory funding requirement on the utilities for a federally conducted research program. The utilities responded by suggesting that they form a private sector consortium to conduct this research

in order to assure relevance of the R&D with respect to the industry and its customers.

EPRI's membership includes more than 700 electric utility members, ranging from the investor-owned utilities like BG&E to public and rural electric cooperatives. They represent about 70 percent of the total electricity sales.

Contributions to EPRI are approved by public utility commissions to ensure that their activities have the broadest public benefit. EPRI manages more than $500 million in research engaging in the kind of research that a utility on its own could not engage in because it is too costly and it is too risky. By joining forces and by joining together in this collaborative effort, EPRI members conduct research such as the Department of Energy does, that is a very broadly applicable research to the electric utility industry—research that would not be undertaken by the private sector on its own.

Under the existing credit, not only is there not an incentive, but there is really a disincentive for this kind of collaborative effort. Because of the way the IRS has interpreted the rules, 35 percent of all costs for collaborative research are disallowed. They not only take the 35 percent off with respect to the contracted-out costs, but—for other reasons—they disallow additional sums against those amounts that the utility industry has paid into for the collaborative research.

We believe that it would be wise for the Congress to consider putting a real incentive into this R&E credit for collaborative research. As I have already indicated, it is the most efficient way to do this very broadly applicable type research, and given that the Federal Government is going to make broad cuts across the board in this type of research, this would be a way to create real incentives to support research vital to our infrastructure.

Thank you very much. I would be happy to answer any questions you may have.

[The prepared statement follows:]

STATEMENT OF JUDITH K. PENSABENE
DIRECTOR, FEDERAL AFFAIRS AND WASHINGTON COUNSEL
BALTIMORE GAS & ELECTRIC CO., BALTIMORE, MD.
ON BEHALF OF MEMBERS OF THE ELECTRIC POWER RESEARCH INSTITUTE

Chairman Johnson and members of the Subcommittee, I appreciate the opportunity to provide testimony on behalf of the member companies of the Electric Power Research Institute (EPRI) regarding the unique nature of collaborative research and the potential benefits of a specific collaborative R&D tax credit modification as an incentive to promote this highly efficient approach to research and development. As difficult funding decisions are being made regarding the nature and level of federal support for technology research and development, we believe it is imperative to examine appropriate ways to encourage the private sector to fund more of these activities.

Federal funding challenges coupled with the transition to a competitive market environment in the utility industry has brought about a foreseeable strain on investment in R&D. Together these factors naturally have an impact on a company's investment in longer term R&D and result in an unintentional "double-hit" to this energy R&D infrastructure. Therefore, we support the inclusion of a 20% credit for investments in collaborative research performed by 501(c)3 not-for-profit scientific and educational organizations as an important component of the R&E credit. It would serve as an incentive for the private sector to maintain its commitment to collaborative research.

An examination of the technology development programs at the Department of Energy shows that EPRI serves as the Department's direct private sector counterpart. As a former counsel on the Senate Energy and Natural Resources Committee, I was responsible for oversight of these programs at DOE, and I can affirm that EPRI has played a pivotal role in the development and deployment of renewable energy , safety enhanced nuclear, cleaner coal-burning, efficient transmission and distribution, and environmental control technologies. EPRI uses an integrated, systems-wide approach to meet the needs of the utility sector, the ultimate customers for these technologies. Due to the scale of these technology areas and their relevance to the overall utility operations, joint investment in research will continue to be necessary to produce technology advances even in light of impending historic changes within the industry. Competition occurs in the strategic application of these technologies into individual systems. BG&G and other member companies will continue to value EPRI as the organization that will take us into the next generation of utility technologies.

ABOUT EPRI

EPRI was founded in 1972 by leaders of the electric utility industry. Due to rolling blackouts in the northeastern United States, Congress was proposing a mandatory fee from utilities to sponsor a federally-conducted research program. The utility industry responded by requesting that it be allowed to establish a private consortium to conduct the research in order to assure the relevance of its R&D to the industry and its customers. Hence, EPRI was founded and has met these criteria ever since.

Membership includes approximately 700 electric utility members ranging from investor-owned, to public, and rural electric cooperatives representing approximately 70% of our nation's electricity sales. EPRI's research covers the breadth of technologies relating to the generation, transmission and distribution, and end-use of electricity. EPRI has a core program that conducts high-risk, cutting-edge science and technology development that provides the basis for new applied technologies in the years to come, as well as, an environmental and health program that distinguishes the possible risks associated with such issues as electromagnetic fields, climate change and air, land and water quality.

EPRI manages research on behalf of its members and has operated as a 501(c)3 organization for the past 20 years. This status requires EPRI to operate in a manner that allows non-discriminatory access to research results. EPRI manages more than $500 million dollars in R&D annually. Membership in EPRI is voluntary and technology priorities are set by member companies. Member company dues are approved by State Public Utility Commissions ensuring that market driven research is consistent with the public interest. EPRI conducts research that is vital to assuring the efficient and economical production and use of electricity with an emphasis on safety, health, and the protection of the environment. The founders of EPRI made a strategic decision not to develop an in-house R&D infrastructure that could become antiquated or that would determine R&D priorities. EPRI draws on the expertise of universities, small business, and many other entities to carry out research and development projects. Due to the unique nature of EPRI, it is able to conduct highly-leveraged, non-duplicative research that would very likely not be carried out by individual member companies or otherwise.

VALUE OF A COLLABORATIVE R&E TAX CREDIT

The goal of an R&E credit was not just to promote R&E but to promote technological innovations that will have a practical, positive impact on the American public's standard of living. In contemplating changes to the credit, the committee should seek to encourage firms to leverage their limited R&D dollars through collaboration. This presents an excellent opportunity to think about the best ways to structure the credit to achieve its ultimate goals.

Again, proposed federal budget cuts across the board suggest that the credit be modified to reward private R&D activities that may be able to absorb some of this research and disseminate the results to the broadest public base possible. The structure of qualified collaborative 501(c)3 research meets both the scale and public benefits tests of this potential shift in responsibility. By pooling resources for R&D, consortia leverage limited individual R&D investment.

THE CURRENT CREDIT

The R&D tax credit is equal to 20% of the excess of (i) a taxpayer's "qualified research expenses" for the taxable year over (ii) the base amount.
Under the current Internal Revenue Code for the R&E credit, "Qualified research expenses" are defined as the sum of (i) in-house research expenses and (ii) contract research expenses. In-house research expenses can be generally viewed as expenses for research directly conducted by the taxpayer (e.g., amounts paid to an employee for research and amounts paid for supplies used in the conduct of that research). Contract research expenses are amounts which will be paid by the taxpayer to a third party for research.
A taxpayer is only entitled to take into consideration for purposes of determining the amount of "qualified research expenses" 65% of the cost of the research contract. This arbitrary 65% ceiling on creditable contract research expenses reflects a decision by Congress to eliminate from the credit, amounts paid for third-party contractor overhead. In other words, Congress determined that for each dollar spent on contract research, 35 cents was for overhead and 65 cents was for qualified research expense.

The statute, however, is silent as to the treatment of membership contributions to a collaborative research consortia. The Internal Revenue Service ("IRS") has taken the position in the utility industry that membership dues paid to a collaborative research consortia should be treated as contract research expenses and thus subject to the 65% ceiling/35% reduction. However, the IRS has taken the additional step of disallowing substantially all of the consortia's overhead expenses from the calculation prior to the 65% ceiling. Instead of 65 cents out of every research dollar spent by the consortia qualifying, now only a significantly lower amount is qualified. Essentially the

IRS is eliminating the overhead TWICE: first, by excluding it from the contract research expense definition; and second, by requiring a consortia member to reduce its contract research expenses by 35% as if such expenses still contained all of the consortia's overhead. This occurs under current law despite the fact that companies do collaborative R&D precisely because it is more efficient to pool resources.

CONCLUSION

The subcommittee's re-examination of the existing R&E credit creates an opportunity to recognize the benefits and efficiencies of collaborative R&D. By stimulating industry-led collaborative efforts, the credit will leverage increasingly scarce research dollars and encourage more efficient use of R&D resources. Collaborative efforts eliminate duplicative research projects, thereby minimizing the cost of the credit to the federal government. The collaborative credit will also stimulate new research -- research unlikely to be undertaken individually because it is too costly, too risky or too long-term. Finally, by making more efficient use of private R&D resources, the collaborative credit will fully and cost-effectively advance the aim and policy rationale behind the existing credit.

Chairman JOHNSON. Thank you.

You will notice that the timing lights are in use. We have a number of panels today, and I hate to limit your comments, but if you would try to abide by the lights, I would appreciate it.

Mr. Olesen.

STATEMENT OF DOUGLAS E. OLESEN, PRESIDENT AND CHIEF EXECUTIVE OFFICER, BATTELLE MEMORIAL INSTITUTE, COLUMBUS, OHIO

Mr. OLESEN. Good morning, Madam Chairwoman—Mr. Portman, thank you for that introduction—and members of the subcommittee. I appreciate the opportunity to be here today to testify on behalf of this very important issue to the competitiveness of this country.

As Mr. Portman indicated, my name is Douglas Olesen. I am president and chief executive officer of Battelle Memorial Institute, which is the world's largest independent research and development organization. Our business is one that serves business across the spectrum of industrial sectors of this country and around the world. We work for small businesses on the one hand, and Fortune 100 companies on the other. As such, we have, I think, an unparalleled opportunity to watch the decisionmaking process in the industrial sector as they go about allocating R&D dollars and making priority decisions among those dollars.

We also track and predict R&D spending in this country every year; we have done that for more than two decades. I have some publications here that deal with R&D spending predictions in the United States for both government and industrial spending, which I will provide to the subcommittee in addition to my prepared statement. These forecasts are published widely in the Wall Street Journal, Business Week, and a lot of other publications every year and are well known for their accuracy, their depth, and content.

What comes out of our studies of R&D is an obvious increasing level of pressure on industrial organizations because of the global competitiveness that they face. This global competitiveness is causing fundamental changes in the R&D structure of this country, much greater pressure on industry to get greater returns out of R&D spending than they ever have in their past.

Also, this greater competition fuels a demand to move more products to market faster than companies have ever done in history, and it also provides pressure to move R&D expenditures much more toward shorter term, existing product improvement kinds of R&D, and increasingly puts pressure on our ability to ensure a long-term investment in our technology base of this country, which ultimately is the base that will generate breakthrough technologies that will be able to revolutionize entire industrial sectors.

It is in this atmosphere that I certainly recommend for your consideration that we give every consideration possible to providing mechanisms by which we can enhance the private sector R&D capacity of this country; and the R&D tax credit is a given individual device by which that can be accomplished. It certainly provides incentives to pay attention to longer term commitment to R&D and will help offset the concern now being felt that long-term R&D is being sacrificed for shorter term.

I also believe that the tax credit, as it has been used, has to some extent failed to fulfill its potential because of the significant changes that have occurred and the undependability of the application of the tax credit. So I would recommend for your consideration, first, that the tax credit be made permanent so that long-term research investments can be viewed with some stability, which is absolutely required if someone is going to stick with long-term R&D.

The second change I would recommend strongly is eliminating the base amount, making the credit nonincremental so that it is based on actual expenditures over the long term.

In total, I believe that the R&D tax credit in this way can be a major incentive to producing long-term research gains which are important to the competitiveness of this country.

Thank you.

[The prepared statement follows:]

STATEMENT OF DR. DOUGLAS E. OLESEN
PRESIDENT AND CHIEF EXECUTIVE OFFICER
BATTELLE MEMORIAL INSTITUTE
COLUMBUS, OHIO

Madam Chairman and Members of the Subcommittee, I appreciate the opportunity to testify before you today on an issue that is very important to the competitiveness of this country.

My name is Douglas Olesen. I am President and Chief Executive Officer of Battelle Memorial Institute. For those of you who don't know, Battelle pioneered the concept of contract research through the vision of our founder in the 1920s. Gordon Battelle, an industrial leader from Ohio, saw the need for an independent research and development capability to serve the evolving industrial enterprise that was forming in this country in the 1920s. He directed that his estate be used to establish a not-for-profit institute to serve this need.

Over the ensuing 65 years, Battelle has grown to become the world's largest independent contract research and development organization, with many offices and laboratories throughout the United States. Our technological achievements have ranged from materials research that aided the steel and aircraft industries, to the development of the office copier (the Xerox machine), to key involvement in the development of hundreds of new products, many of which we all use every day, such as the sandwich coin, compact discs, holograms, and even golf balls that resist splitting.

In 1994, Battelle conducted nearly $1 billion in research and development for industry and government. Our industrial clients range from small businesses to the largest corporations in the Fortune 100. Many of our industrial clients look upon us as a bridge that can link basic research to a finished product on the store shelf. Putting technology to work for industry and government is our goal and the underlying basis of our business.

With our long history of working hand-in-hand with industry on practical technologies, I believe we can offer a well-informed perspective on the issue at hand. In fact, our contract research work for industry serves as the means by which many companies utilize the R&D tax credit. Additionally, since Battelle is taxed under subchapter C, just as any corporation, we have also utilized the R&D tax credit ourselves, with our own internal research projects.

In our business, it is vitally important for us to monitor industrial R&D trends. For instance, every year we produce a forecast of R&D spending in the United States. Over the past two decades, those forecasts have been reported on widely in publications such as the *Wall Street Journal* and *Business Week*, and they have come to be known for their accuracy.

One of today's most important trends affecting industrial R&D that we have witnessed is the pressure from ever-stronger global competition. This unprecedented competition from around the world has served to increase pressures for companies to maximize the return from their technology investments. Greater competition has also fueled demands to move more new products to the marketplace faster than ever, leading many companies to direct more of their R&D investments toward short-term development and immediate problem-solving to reduce costs and link R&D investments more closely to specific products. But also, the increasing global competition has led to concerns over ensuring the health of our long-term technology base and has increased pressure on many companies' ability to sustain long-term research and development programs that can lead to the breakthrough technologies that can dramatically transform an entire industry. Today, businesses must juggle these various demands--which often appear to be mutually exclusive.

In this atmosphere, we need to do everything we can to encourage the build-up of private sector R&D capacity. The R&D tax credit is a very significant element for government to provide a business climate that stimulates both short- and long-term

industrial research in the private sector. Obviously, a tax credit cannot do this job alone. In all my years in the technology business, I have never heard anyone say that they conducted any research or did not conduct a research project solely because of a tax credit. Nevertheless, the R&D tax credit represents the type of positive action that can be one of the most effective methods for government to promote industrial research and create a business environment that nurtures growth and competitive strength in the private sector.

The R&D tax credit provides an added economic incentive to invest in research and development, thereby offsetting a portion of the rising R&D costs that we will witness as technology continues to grow more complex and more expensive. Further, the tax credit can serve as a more efficient method for government to support industrial R&D than direct funding of specific R&D projects, because it allows industry to make the decisions about what technology is needed to improve our industrial competitiveness. Today, we are living in a world that has become more consumer-pull rather than technology-push. Because consumers are becoming increasingly sophisticated, technology development is more and more focused on a rapid response to consumer needs, and the leaders of industry know those needs better than anyone else. The primary goal of a government technology policy, I believe, is simply to create a business atmosphere that encourages growth, competitiveness, and technological risk-taking. In such an atmosphere, our industrial leaders are better able to make the necessary technological investments that will help keep them competitive over the long term.

By establishing this positive, risk-friendly environment, we can build competitive capacity in the private sector and establish a sound blueprint for creating jobs and sustaining economic growth.

I believe, however, that the R&D tax credit, over the past several years, has not been able to fulfill its potential. The R&D tax credit would more effectively meet its goal with two changes that I would like to submit to the Committee.

First, I recommend that the credit be made permanent.

Research is often a long-term endeavor, and a permanent R&D tax credit would better allow industry to plan long-term research investments. Since the credit has been allowed to expire five times in the past 14 years, industry has not been able to count on the credit being available for long-term R&D commitments. As a result, it has been more difficult for planned long-term R&D projects to come in line with ever-increasing business demands to lower costs and obtain a rapid return on investment.

The second change I would recommend is eliminating the base amount, making the credit non-incremental, and basing the credit on actual R&D expenditures.

Companies that maintain a constant R&D investment over a number of years should be rewarded for their long-term efforts, as well as those companies that increase their R&D investments from one year to another. It is through this long-term investment that companies can best develop the depth in their research and development efforts that will give them the capability of developing breakthrough technologies.

In conclusion, I would like to stress the importance of building competitive strength in the private sector. Over the past few years, overall industrial R&D spending has been flat or has shown only moderate increases, and R&D spending in the government sector is now on the decline. Yet, in most major industries, technology is a critical driver in today's global marketplace.

The companies that can capture the best technology and bring it to the marketplace the quickest, the companies that can use technology to offer their products and services faster, better, and cheaper—those are the companies that will have a strong competitive advantage. For today and tomorrow, one of the most effective ways to build

a solid and long-term competitive edge will be through technology. Our investments in technology are among the most critical investments we are making today.

Certainly, there are a number of government policies that affect R&D spending levels and that can help provide industry with the added incentive to increase technological investments. The R&D tax credit is one such tool that we can utilize more efficiently to establish a business climate that stimulates the development of innovative technologies, industrial growth, and economic well being.

Thank you.

Chairman JOHNSON. Thank you, Mr. Olesen.
Dr. Hooker.

STATEMENT OF MICHAEL HOOKER, PH.D., PRESIDENT, UNIVERSITY OF MASSACHUSETTS, ON BEHALF OF THE NEW ENGLAND COUNCIL, BOSTON, MASS.

Mr. HOOKER. Madam Chair, members of the subcommittee, my name is Michael Hooker, I am president of UMass, the University of Massachusetts. I am pleased to have the opportunity to testify before you this morning on an issue that I believe is critical not only to sustaining our economic recovery, but also to securing our economic prosperity in a highly competitive knowledge-based economy of the 21st century. I am testifying today on behalf of The New England Council.

The Council is the nation's oldest regional business organization comprised of the leading manufacturers, service industries, colleges and universities, financial institutions, public utilities, and technology companies in the six-State New England area.

I want to commend you, Madam Chair, for holding hearings on the need to permanently extend the R&D tax credit and for your leadership along with that of Representative Richard Neal of Massachusetts in introducing H.R. 803, a bill to permanently extend the credit.

I also want to acknowledge the efforts of Massachusetts Governor William Weld, who has been a tireless advocate and leader among the Nation's Governors for a permanent Federal increase. My remarks this morning will focus less on the structure of the credit and more on the importance of permanence for the credit.

Let me begin with some specifics of the New England economy and why research and development is so important there. To appreciate where we are, we must realize where we have been. The recession of the late eighties and early nineties was longer and deeper for New England than for any other region of the country. New England lost 850,000 jobs during this time period. This amounts to 25 percent of the jobs lost nationwide and 13 percent of our region's total employment. Only 37.5 percent of the jobs are back. While our economy has clearly improved, we still have a long way to go to get back to the prerecession levels.

When you are preparing nearly 60,000 students for the workplace, as we are this year at UMass, these employment numbers are of great concern.

Despite the results of the recession, I believe that New England can have a very bright future and a robust economy. We are home to some of the best research universities and teaching hospitals in the world, education is a major component of our economy, and we have the highest concentration of educational facilities of any region in the country. New England produces highly educated and innovative individuals.

Gone, for the most part, are the days of agriculture in New England. Today, the New England economy is based on knowledge and information. It is no coincidence that clustered around New England's educational institutions are small, startup firms and entities that grew out of the research and the work that is performed and nurtured by our institutions.

Our recovery has been fueled largely by entrepreneurship in small and medium-sized firms, many based on sophisticated technology. Absent an environment conducive to growing these kinds of new businesses, we are doomed to a prolonged period of stagnant growth and limited opportunities for this and future generations.

New England is at a crossroads. We have the potential to grow and prosper in some of the most advanced and exciting markets in the world, creating high-paying and meaningful jobs. The business climate is a critical component of our success. The Federal Government has a very important role in promoting the development of this potential. Public policies that encourage and require long-term investment are necessary for our economic future.

Incentives like the R&D tax credit have helped New England's emerging industries to grow and thrive. Our high technology, biotech, software and chemical sectors all benefit from the credit. For these industries, research activities translate directly into high-wage jobs, which is music to the ears of those 60,000 UMass students who will soon be looking for work. In fact, it is the cost of wages and salaries related to R&D that make up most of the credit-eligible expenses. Indirectly, research is the key to tomorrow's products, methods, and new sources of economic development.

Although the R&D tax credit has proven to be an effective means of increasing private sector investment and improving the Nation's overall competitiveness, its incentive value is limited because of its temporary nature and uncertain future. In order for the private sector to fully realize the benefits of this credit, it must be made a permanent feature of the Tax Code. This is the only way to encourage the long-term growth that is most needed in New England.

Most R&D projects span over 5 to 10 years. A temporary credit can actually inhibit a company's ability to judge and plan for more lengthy projects. In most cases, it is the longer term projects that are more risky, yet also that provide the most economic benefit in the years ahead.

The New England Council strongly believes that a permanent R&D tax credit will significantly enhance its incentive value and improve the competitive position of the region. In fact, the Council coordinated a letter signed by over 100 companies which was sent to the New England congressional delegation and the congressional leadership supporting permanence for the credit.

Now, more than ever, New England needs a business climate which fosters the development of new technologies and industries. Research and development can lead to advances in science and technical knowledge, which in turn lead to productivity improvements and long-term economic growth.

I urge you to enthusiastically support and enact H.R. 803.

Thank you, Madam Chair.

[The prepared statement and attachment follow:]

THE
NEW ENGLAND
COUNCIL

Testimony of Dr. Michael Hooker
President, University of Massachusetts

On Behalf Of
The New England Council

Before
the U. S. House of Representatives
Committee on Ways and Means
Subcommittee on Oversight

May 10, 1995

Madame Chair and Members of the Subcommittee, my name is Michael Hooker I am the President of the University of Massachusetts. I am pleased to have the opportunity to testify before you this morning on an issue that I believe is critical to sustaining an economic recovery not only in New England but across the nation as well.

UMASS is a public university system with facilities located on five different campuses in the state. Beginning with our flagship in Amherst we also have campuses in Lowell, Dartmouth, Boston and the Medical Center in Worcester. First established in 1863 as a land grant university, UMASS was chartered to support the state's agriculture and mechanical arts.

I am testifying today on behalf of the New England Council. The Council is the nation's oldest regional business organization comprised of the leading manufacturers, service industries, colleges and universities, financial institutions, public utilities and technology companies in the six-state area.

I want to commend you, Madame Chair, for holding hearings on the need to permanently extend the R & D tax credit, and for your leadership - along with Representative Richard Neal of Massachusetts - in introducing HR 803, a bill to permanently extend the credit. I also want to acknowledge the efforts of Governor Weld who has been a tireless advocate and leader among the nation's governors for a permanent federal credit.

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My remarks this morning will focus less on the structure of the credit and more on the importance of permanence for the credit.

Let me begin with some specifics of the New England economy and why research and development is so important. To appreciate where we are we must realize where we have been. The recession of the late eighties and early nineties was longer and deeper for New England than any other region of the country. We lost 850,000 jobs during this time period. This amounts to 25% of jobs lost nationwide and 13% of our region's total employment. Only 37.5% of the jobs are back. While our economy has clearly improved we still have a long way to go to get back to pre-recession employment levels.

Despite the results of the recession, I believe New England can have a very bright future. We are home to the some of the best universities, institutions of higher learning, teaching hospitals and laboratories. Education is a major component of our economy and we have the highest intensity of these facilities of any region in the country. New England produces highly educated and innovative individuals.

Gone, for the most part, are the days of agriculture. Today the New England economy is based on knowledge and information. It is no coincidence that clustered around New England's educational institutions are small start-up firms and entities that grow out of the research and work that is performed and nurtured by our institutions.

Many in New England believe that our recovery has been fueled by small and medium sized firms, many in high-tech, biotech and entrepreneurial ventures. Absent an environment conducive to "growing" these kinds of new businesses, we are doomed to a prolonged period of stagnant growth and limited opportunities for this and future generations.

New England is at a crossroads. We have the potential to grow and prosper in some of the most advanced and exciting markets in the world creating high paying and meaningful jobs. The business climate is a critical component of our success. The federal government has a very important role in promoting the development of this potential. Public policies that encourage and reward long term investment are necessary for our economic future.

In 1981, President Reagan established the R & D tax credit for the sole purpose of increasing U. S. productivity by spurring growth in our technology-based economy. Recognizing the importance and effectiveness of the provision, the U. S. Congress has extended the credit six times since then.

Incentives like the R & D tax credit have helped New England's emerging industries to grow and thrive. Our hi tech, biotech, software and chemical sectors all benefit from the credit. For these industries research activities translate directly into high wage jobs. In fact, it is the cost of wages and salaries related to R & D that make up most of the credit-eligible expenses. Indirectly research is the key to tomorrow's products, methods and new sources of economic development.

The importance of the credit to New England can be seen in the following statistics:

* In 1991, New England spent over $11 Billion on R & D activities;

* Massachusetts was number five in the country in total R & D investment, spending over $8 Billion in 1991;

* Top industry credit earners are computers, computer software, pharmaceuticals and biotechnology, all successful growth industries in the region;

* Although the bulk of R & D is still performed by large companies, small businesses are an increasingly important source of R & D spending and an important source of job creation in New England.

Although the R & D tax credit has proven to be an effective means of increasing private sector investment and improving the nation's overall competitiveness. Its incentive value is limited because of its temporary nature and uncertain future.

In order for the private sector to fully realize the benefits of the R & D tax credit it must be made a permanent feature of the tax code. This is the only way to encourage the long term growth that is most needed in New England. Most R & D project span over five to ten years. A temporary credit can actually inhibit a companies ability to judge and plan for a more lengthy project. In most cases it is the longer term projects that are more risky, yet also provide more economic benefit in years ahead.

The New England Council strongly believes that a permanent R & D tax credit will significantly enhance its incentive value and improve the competitive position of the region. In fact, the Council coordinated a letter signed by over one hundred companies and sent yesterday to the New England Congressional delegation and the congressional leadership supporting permanence for the credit. Madame Chair I respectfully request that a copy of the letter, along with the list of companies who have endorsed it, be made a official part of the record of this hearing. If permanent, corporations will be able to rely upon continued availability of the credit when making long term R & D investment and overall business decisions.

Now more than ever New England needs a business climate which fosters the development of new technologies and industries. Research and development leads to advances in scientific and technical knowledge, which in turn leads to productivity improvements and long-term economic growth. A permanent federal R & D tax credit will provide the necessary incentive for continued economic recovery for New England. I urge you to enthusiastically support and enact HR 803. Thank you.

THE
NEW ENGLAND
COUNCIL

May 9, 1995

The Honorable Bill Archer
Chairman, Committee on Ways and Means
1102 Longworth House Office Building
Washington, D. C. 20515

Dear Mr. Chairman:

The undersigned urge you to enact a permanent research and development tax credit as part of the Fiscal Year 1996 Budget legislation. As the present R & D credit will expire on June 30, 1995, the inclusion of a permanent credit in the FY96 Budget legislation will be a major signal to the U. S. research community and industries such as ours that the credit will continue.

We know that the Congressional Leadership considers long-term economic growth a high priority and appreciate your consistent efforts on behalf of a permanent R & D tax credit.

The six state New England region, abundant with high technology companies, universities, colleges, laboratories and teaching hospitals, is on the cutting edge of information and technology. At a time when our economy is still recovering from a prolonged and deep recession, incentives like the R & D tax credit allow companies to utilize these resources in pursuit of new products and services, while also providing high-paying jobs to highly skilled workers.

Investment in R & D has proven vital to the technical innovation and productivity enhancements that are necessary to maintain a competitive position in the world marketplace. As significant as the benefits of the credit are, they have been reduced by its temporary nature. Uncertainty over the future of the credit reduces its incentive value since most R & D projects are long-term efforts, spanning 5-10 years.

Research and development activities hold great promise for New England's high-tech economy. We are poised for significant growth provided the business climate is one which stimulates and facilitates long-term investment. We believe permanent extension of the R & D tax credit will create this kind of environment. We thank you for your past support and urge you to actively support inclusion of a permanent R & D tax credit in the FY96 Budget legislation.

Sincerely,

Richard Chapman, President & CEO, Vermont Electric Power Co., Rutland, VT
William Meagher, Managing Partner, Arthur Andersen, Boston, MA
James Manzi, President & CEO, Lotus Development Corp., Cambridge, MA
Hugh MacKenzie, President & Retail Business Group, Northeast Utilities, Hartford, CT
Joanna Lau, President & Chairman, Lau Technologies, Acton, MA
Edward Johnson, Chairman & CEO, Fidelity Investments, Boston, MA

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John Rowe, President & CEO, New England Electric System, Westborough, MA
Jack Rennie, Chairman & CEO, Pacer Systems, Billerica, MA
Anthony Dolphin, President & CEO, Springboard Technology, Springfield, MA
William Van Faasen, President & CEO, Blue Cross & Blue Shield of Massachusetts, Boston, MA
Robert Hunter, CEO, Delta Dental Plan of Massachusetts, Medford, MA
Paul Barrett, CEO, Boston Energy Group, Boston, MA
Donna DiBella, President, Patient Care of Connecticut, Wethersfield, CT
Henri Termeer, Chairman & CEO, Genzyme Corporation, Cambridge, MA
William Roland, President, Megapulse, Bedford, MA
John Hamilton, Managing Partner, Hale and Dorr, Boston, MA
Thomas May, Chairman & CEO, Boston Edison Company, Boston, MA
Ira Stepanian, Chairman & CEO, Bank of Boston, Boston, MA
Donald Reed, President & Group Executive, NYNEX Corporation, Boston, MA
Mitchell Kertzman, CEO, Powersoft Corporation, Concord, MA
Joseph Boren, Chairman & CEO, Metcalf Eddy, Wakefield, MA
Michael Hooker, President, University of Massachusetts, Boston, MA
John Kreick, President, Lockheed Sanders, Nashua, NH
Vincent Rocco, Chairman & CEO, TRC Companies, Windsor, CT
George Hatsopoulos, President & Chairman, Thermo Electron Corp., Waltham, MA
Jonathan Fleming, Proprietor, CT Defense Support & Diversification, Rocky Hill, CT
Dr. J. Richard Gaintner, President & CEO, New England Deaconess Hospital, Boston, MA
Roger Young, President & CEO, Bay State Gas Company, Westborough, MA
Kija Kim, President & CEO, Harvard Design and Mapping Company, Cambridge, MA
Marc Rosen, Vice President of Government Affairs, A T & T, Boston, MA
Preston Jordan, CEO, Blue Cross Blue Shield of Vermont, Montpelier, VT
James DiStasio, Managing Partner, New England Area, Ernst & Young, Boston, MA
William Haney, President & CEO, Molten Metal Technology, Waltham, MA
Kenneth Quickel, President, Joslin Diabetes Center, Boston, MA
William O'Neill, Jr., EVP & CFO, Polaroid Corporation, Cambridge, MA
Stephen Wilmarth, CFO, Alliance International, Deep River, CT
Frederick Lofgren, CFO, Hitchiner Manufacturing, Milford, NH
Bryan Carlson, President, Mount Ida College, Newton Centre, MA
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Stephen Woodsum, Managing Partner, Summit Partners, Boston, MA
Lawrence O'Toole, President & CEO, Nellie Mae, Braintree, MA
Marianne Lancaster, President, Lancaster Packaging, Hudson, MA
Martin Kofman, Partner, Kofman & Company, Chestnut Hill, MA
Joseph Norberg, CFO, Hill, Holliday, Connors, Cosmopulos, Boston, MA
George Sage, President & Treasurer, Bonanza Bus Lines, Providence, RI
Thomas Robinson, President, The Entwistle Company, Hudson, MA
Edwin Smith, Chairman & CEO, Brockway-Smith Company, Andover, MA
Robert Fiscus, President & CFO, United Illuminating Co., New Haven, CT
Edward Shooshanian, Chairman, Shooshanian Engineering Associates, Boston, MA

Robert Morrow, Vice President, DB Riley Consolidated, Worcester, MA
John Hoy, President, New England Board of Higher Education, Boston, MA
Kenneth Kasses, Executive Vice President & President, Radiopharmaceuticles Division, The Dupont Merck Pharmaceutical Company, Billerica, MA
Marjorie Beck, President, MRB Media Services, Windsor, CT
Thomas Maloney, CFO, John Hancock Mutual Life Insurance, Boston, MA
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John Davis, President/Treasurer, American Saw & Mfg., East Longmeadow, MA
Steve Duplessie, CEO, Invincible Technologies Corp., Franklin, MA
Thomas Aceto, President, North Adams State College, North Adams, MA
John Curry, President, Northeastern University, Boston, MA
Daniel Grady, Vice President, Finance & CFO, Bose Corporation, Framingham, MA
Richard Verney, Chairman & CEO, Monadnock Paper Mills, Bennington, NH
Donald Sundberg, Interim Vice President, Research & Public Service, University of New Hampshire, Durham, NH
Russell Stephens, Senior Vice President, Continental Cablevision of NE, Andover, MA
Dean Langford, President, Osram Sylvania, Danvers, MA
Ross George, President & CEO, Simonds Industries, Fitchburg, MA
Peter Gwyn, President & CEO, Bird-Johnson Company, Walpole, MA
David Hunter, CFO, Micrion Corporation, Peabody, MA
Leon Hirsch, CEO, United States Surgical Corporation, Norwalk, CT
Michael Lucy, Senior Vice President, J. Makowski Company, Boston, MA
K. Grahame Walker, Chairman & CEO, The Dexter Corporation, Windsor Locks, CT
Michael Besson, President & CEO, Norton Company, Worcester, MA
Harron Ellenson, Harron & Associates, Boston, MA
Robert Hirschman, President, Whitman & Howard, Wellesley, MA
William Russell, CEO, Fulflex, Middletown, RI
John Kortecamp, President, The Alliance Foundation, Portland, ME
George Campbell, President, The Maine Alliance, Portland, ME
Richard Ayers, Chairman & CEO, The Stanley Works, New Britain, CT
Craig Frew, President, Iroquois Pipeline Operating Company, Shelton, CT
John Silber, President, Boston University, Boston, MA
John Mahoney, President, Health Insurance of Vermont, Colchester, VT
Daniel Hannify, President, G. S. Precision, Brattleboro, VT
Charles Drewes, President, Polymers, Middlebury, VT
Kymus Ginwala, President, Northern Research & Engineering Corp., Woburn, MA
Morris Levy, Senior Vice President, Parsons Brinckerhoff, Boston, MA
Peter D'Angelo, Executive Vice President & CFO, Raytheon Company, Lexington, MA
Peter Hunter, VP & CFO, Data Instruments, Acton, MA
Lawrence Gannon, CEO, Keyes Associates, Providence, RI
J. Thomas Robinson, President, Nyacol Products, Ashland, MA
Peggy Stock, President, Colby-Sawyer College, New London, NH
Robert Carothers, President, University of Rhode Island, Kingston, RI

Thomas Vanderslice, Chairman & CEO, M/A Com, Lowell, MA
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Richard Egan, Chairman, EMC Corporation, Hopkington, MA
Victoria Bondoc, CEO, Gemini Industries, Bedford, MA
Conrad Grondin, CEO, Prescott Metal, Biddeford, ME
Joseph Mullaney, Vice Chairman, The Gillette Company, Boston, MA
Harry Hartley, President, University of Connecticut, Storrs, CT
Betty Diener, Executive Director, Environmental Business Council, Boston, MA
Thomas Yale, President, Yale Cordage, Portland, ME
Jack Blais, President, OFC Corporation, Natick, MA
Paul Montrone, President & CEO, Fisher Scientific International, Hampton, NH
William Mitchell, President & CEO, Nashua Corporation, Nashua, NH
Harold Hitchen, CFO, Amica Mutual Life Insurance, Lincoln, RI
Ronald Cass, Dean, Boston University School of Law, Boston, MA

cc: Hon. Newt Gringrich

Chairman JOHNSON. Thank you, Dr. Hooker.
Mr. Anderson.

STATEMENT OF CHRISTOPHER R. ANDERSON, GENERAL COUNSEL, MASSACHUSETTS HIGH TECHNOLOGY COUNCIL, INC., WALTHAM, MASS.

Mr. ANDERSON. Thank you, Madam Chair, members of the subcommittee. My name is Christopher Anderson, general counsel of the Massachusetts High Technology Council, Inc. We urge you and other Members in Congress to support this very timely initiative to make the Federal research and development tax credit permanent.

I would also like to thank, in addition to your efforts, Madam Chair, the efforts of the Massachusetts delegation that have signed on as cosponsors, Congressmen Blute, Frank—we expect Marty Meehan to be an official sponsor soon—Moakley, Neal, and Studds. My plane doesn't leave until 7:30 tonight so I still have time to get a few more for you before I leave.

This is the first time the High Tech Council has testified in Washington. Our primary focus is on Massachusetts public policy issues to make Massachusetts more competitive than other States for high technology companies. Our efforts have been aided significantly by Governor Weld to help improve the climate for high technology in Massachusetts. We compete now with California, Texas, North Carolina, and other States who are becoming very aggressive.

The Federal research and development tax credit would address similar competition from other nations for our research and development activities. Therefore, the goal which you stated today, to evaluate what the policy objective is, I think is probably twofold. One is to encourage additional research and development spending in this country and see, through a policy vehicle, how the Federal Government can reduce the cost of capital and encourage further economic growth.

Providing industries that are committed to expanding their R&D commitments in the United States with a permanent extension of the Federal R&D tax incentive will help achieve both of those objectives.

Very specifically, the Massachusetts High Technology Council believes an effective research and development incentive should have two key features. It must be incremental, and it must be permanent. That view isn't shared by everyone, I understand. However, we believe that this does achieve the objective—the policy objective of creating and rewarding those industries and companies that actually do more.

Now, there are a couple of limitations, and I will divert from my written comments and request that they be submitted in the record here. Let me just comment briefly on a point that has come up and I am sure will come up again.

That point is cost. While not being from inside the beltway, and fully understanding how the game works, the static nature of revenue projections have never told the whole story in the view of the high technology community in Massachusetts. We would prefer to view incentives and evaluate them based on a more dynamic model of revenue impact; and as Congressman Meehan and others have

alluded to, there are dynamic factors, job multipliers, that do demonstrate that this is a job-generating, revenue-enhancing vehicle that proves that you can actually grow the revenue pie without raising taxes.

So we would not concede a cost, and we would rather focus on the dynamic elements of what the research and development tax credit leads to, both in terms of job growth and in terms of tax revenue.

The Massachusetts High Technology Council played a key role in the development of a permanent State-level research and development tax credit in our State, and one key distinction that we made versus similar credits adopted by other States and by the Federal Government was that it was permanent and provides investors with crucial decisionmaking factors of certainty and stability.

As Dr. Hooker mentioned, Governor Weld has played a very active and aggressive role in helping to lead the charge of the Nation's Governors to make this tax credit permanent. He sent a letter to Chairman Archer 2 days ago. I have a copy of that letter here, but I would like to officially request that it be included in the record if possible.

Chairman JOHNSON. Without objection.

[The information follows:]

THE COMMONWEALTH OF MASSACHUSETTS
EXECUTIVE DEPARTMENT
STATE HOUSE • BOSTON 02133
(617) 727-3600

WILLIAM F. WELD
GOVERNOR

ARGEO PAUL CELLUCCI
LIEUTENANT GOVERNOR

May 8, 1995

The Honorable Newt Gingrich
Speaker of the House
H-232 Capitol Building
Washington, DC 20515

Dear Mr. Speaker:

As you know, the federal research and development tax credit is scheduled to expire on June 30, 1995. As Governors of seven of the largest industry-based R&D states in the nation, we are writing to seek your assistance in securing a permanent extension of the federal R&D tax credit. We believe this is the type of market-based, pro-growth tax policy that our party should champion.

In 1981, President Reagan signed into law a four-year R&D tax credit to help stimulate the growth and competitiveness of our technology-based economy. The results have been impressive. Recent studies indicate that the marginal effect of one dollar of the R&D credit stimulates approximately one additional dollar of private research and development spending over the short run, and as much as two dollars of extra R&D in the long-run. Today, in our seven states, the private sector alone spends more than $60 billion per year on R&D. These investments support thousands of highly skilled employees in some of our nation's most promising industries, such as computer hardware and software, biotechnology, telecommunications, pharmaceuticals, and environmental technologies.

As significant as the benefits of the R&D credit are, however, they have been limited by the credit's temporary nature and uncertain future. Since its inception, the R&D credit has been allowed to expire five times, being renewed once retroactively. This uncertainty has hampered the private sector's ability to rely on the credit, forcing many research planners to discount its value when calculating long-term R&D related investments. Given the lengthy nature of R&D projects--frequently spanning five to ten years--permanent extension of the credit would greatly enhance its incentive value and overall effectiveness in stimulating increases in private sector R&D.

Unfortunately, the problems posed by the temporary nature of the credit are also exacerbated by our foreign competitors' generous tax incentives for R&D, including deductibility of current research expenses and special tax credits. Such incentives have caused many U.S. employers to consider the option of transferring their R&D functions overseas to remain competitive in the international marketplace. As a result, our nation runs the risk of becoming an importer, rather than an exporter, of technology and technologically advanced products in the years ahead.

We believe that the Republican Party has a unique opportunity to demonstrate to employers and the nation that we are committed to the principles of long-term economic growth and smaller government, a permanent R&D tax credit delivers both these principles. As a market-based incentive, a permanent R&D tax credit keeps Washington out of the game of picking winners and losers, while fostering an environment conducive to rewarding the patient, technologically based investments of our finest entrepreneurs. By letting the private sector do what it does best, the credit is one of the federal government's most effective means of encouraging real economic growth in the twenty-first century.

Your support is vital to enact a permanent credit in 1995. We look forward to working with you to achieve this important goal in the months ahead.

Sincerely,

Governor Bill Weld

Governor Pete Wilson

Governor George E. Pataki

Governor John Engler

Governor Christine T. Whitman

Governor Jim Edgar

Governor George W. Bush

Mr. ANDERSON. Former Senator Paul Tsongas has long advocated and recognized the value of a permanent R&D tax credit, and as a matter of fact, so too has Massachusetts Congressman Joe Kennedy, so I would expect that the meeting of the minds has been achieved here; and the real question that we ought to be asking shouldn't be, how can we afford this incentive for increased research and development activity. Instead, today, we should ask what action might we take today to provide a long-term boost to our economy.

This is such an action you should take today, and we appreciate your role and the subcommittee's role in helping make sure that this is the last hearing on an extension of the research and development tax credit, and that when the subcommittee concludes its action and Congress does, that we are talking about a permanent incremental tax credit.

[The prepared statement follows:]

MASSACHUSETTS HIGH TECHNOLOGY COUNCIL

Dedicated To Growth ... Committed To Action

Testimony of:
Christopher R. Anderson, General Counsel
Massachusetts High Technology Council, Inc.

Submitted to the United States House of Representatives
Committee on Ways and Means
Subcommittee on Oversight

in *Support* of H.R. 803 making the current
Research and Development tax incentive Permanent

Hearing Date: May 10, 1995

The Massachusetts High Technology Council urges the House Ways & Means Committee's Subcommittee on Oversight to support H.R. 803 sponsored by Congresswoman Nancy L. Johnson (R-CT) and co-sponsored by more than 50 other Representatives to make the current "job-generating" incremental research and development tax incentive permanent. This incentive, first adopted in 1981, is scheduled to expire on June 30, 1995.

Research and development is the basic ingredient in the process of innovation which leads to improved productivity, products and services which in turn result in increased efficiency, reduced costs and improved quality of life for many people throughout the world. While helping to facilitate increased research and development, a permanent, federal incremental research and development tax incentive will also have a significant and positive long-term impact on economic growth in the United States, help to create needed jobs, increase competitiveness, reduce the cost of capital, and generate revenue without raising tax rates.

There is no serious dispute among economists or policy makers about the fact that an environment that stimulates and facilitates the process of innovation is essential to continued growth. However, during the past 50 years, 40 percent of America's research and development was related to Defense Department objectives. Some of those military technologies became important civilian products, but did so as spin-offs from defense related objectives rather than by the pursuit of specific commercial and industrial objectives.

By the early 1990s, the nation's technology industries had already begun a transition away from shrinking federal defense spending. The key problem now is how to facilitate growth in important technologies to enable U.S. industries to be more competitive in a global commercial economy.

Investments in R&D and in capital equipment are the principal mechanisms by which new technology is created and deployed. The high cost of capital in the United States as compared to that of other countries, has the effect of retarding these investments and thus retarding relative

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productivity growth. Providing industries that are committed to expanding their R&D commitments in the United States with a permanent extension of the federal R&D tax incentive will help lower that cost.

Specifically, the Massachusetts High Technology Council believes an effective research and development incentive should have two key features: it must be incremental, and it must be permanent.

In urging President Clinton to support a permanent R&D tax incentive, Massachusetts Governor William F. Weld (R) said "Massachusetts has benefited greatly since we enacted the country's most generous tax incentive for research and development. We've already seen companies either move here or expand in Massachusetts to take advantage of the tax credit."

Former U.S. Senator Paul Tsongas (D-Massachusetts) said providing for a permanent research and development tax incentive "should be self-explanatory." "We can't compete long-term if we are not putting our earnings back into research and development. Such reinvestment into a company should be viewed as the corporate investment of highest priority and taxed accordingly."

U.S. Representative Joseph P. Kennedy II (D-Massachusetts) urged Congress to permanently restore the R&D tax incentive, saying "the R&D tax credit has provided a valuable economic incentive for U.S. high tech companies to increase investment in R&D in order to enhance their competitiveness in the world marketplace. The growth and prosperity of our economy here in New England and across the nation depends on the kind of investment-friendly climate that the credit provides."

The Massachusetts High Technology Council played a key role in passage of a permanent state-level research and development tax incentive in 1991. We believe Massachusetts now has the most attractive state-level R&D tax incentive in the United States. This law creates an important tax incentive for incremental increases in R&D investments in Massachusetts. For many Massachusetts employers and researchers on our public and private university campuses, this incentive is a visible change in Massachusetts tax policy which demonstrates the Commonwealth's commitment to re-establishing an investment-stimulating, job-creating, pro-research climate.

The purpose of the Massachusetts R&D tax incentive is straight-forward: it is designed to influence future decisions on where and even how much R&D is conducted. It was modeled on the federal R&D language in effect at the time, and has a number of distinct advantages over similar R&D incentives in other states. One key distinction is that it is permanent, providing investors with the crucial decision-making factors of certainty and stability.

In addition, we are currently working to amend the Massachusetts R&D incentive in two ways that could also be adopted on the federal level. One amendment would allow for a one-time election of a new 4-year base period ranging between 1983 and 1995 from which to calculate the qualifying incremental increases in R&D expenses. Another amendment would allow reductions in defense-related R&D to be excluded from the calculation of incremental growth in commercial R&D. Both of these new features will provide companies with additional flexibility to increase the "incentive" value of the credit while preserving the important "incremental" requirement and are

particularly helpful to companies making the transition from defense-related to commercial R&D activities. We urge you to consider these two features as well.

We believe a permanent, federal incremental R&D tax incentive will stimulate additional research activity, thereby increasing jobs and revenue, both in the short run and in the long run when successful new products and services are brought to market. In this context, the question shouldn't be: How can we afford this incentive for increased research and development activity? Instead we should ask: What action might we take today to provide a long-term boost to our economy? This is such an action you should take today.

We urge the House Ways & Means Committee's Subcommittee on Oversight to support H.R. 803 making the current research and development tax incentive permanent.

About the Massachusetts High Technology Council:

The goal of the Massachusetts High Technology Council is to help make Massachusetts the world's most attractive place in which to live and work, and in which to create, operate and expand high technology businesses.

The Council is a non-profit, non-partisan corporation made up of 200 entrepreneurial and respected chief executive officers of Massachusetts high technology companies -- employing more than 300,000 people.

Because it holds no political affiliation, the Council is free to focus on any issue which affects the Massachusetts economy, and to take a firm leadership role in instituting change wherever it is needed.

Since the Council's founding in 1977, it has advocated for, and ultimately influenced, state policies which have helped improve the business climate for the Massachusetts high tech industry. Today, its advice and support is sought on a wide variety of issues by members of the state legislature, the Governor's office, the national media, the education community, and other organizations, both public and private, in Massachusetts and around the world.

Chairman JOHNSON. Thank you, Mr. Anderson.

I thank the panel for your testimony.

I want to ask you all, which do you think would encourage greater research, the incremental structure that is in the current law, though possibly adjusted, or a flat tax at a lower rate?

Mr. ANDERSON. I would be willing to take a stab at that.

Chairman JOHNSON. One of the reasons this is important, I think the point that Dr. Olesen made about depth is very important, and when you look at how we can focus this in a way that it will help small business as well as big business, a flat tax on research and development investment may be more important than maintaining the incremental approach. It also may be a lot easier to administer.

But this is a fundamental issue. I want to get your input; I am going to be asking the other panels, too. We need to know whether we need to really write this all over again, or whether we need to look at base year modifications and that kind of thing.

Mr. ANDERSON. If I could just briefly respond, then other members of the panel.

We have endorsed the incremental approach. Corporations are people, they are a collective group of people, so the initial debate really is, should we tax corporations at all since the people who make up these companies end up generating wealth, paying income taxes, and generating other sources of revenue. The fact that there is a corporate income tax at all leads to this discussion of tax credits applied to the general tax.

I think in a pure environment there shouldn't be a tax on corporations and therefore the discussion ends at that point. It is not very realistic to expect a nonincremental credit, because you get around one of the key objectives of the current system, and that is to encourage incremental increases, or reward increases, and not reward those who may actually benefit from a nonincremental credit by making reductions in their research and development expenditures. So in that context, I think we would encourage remaining with the incremental nature of the credit and, as we have in Massachusetts, provide for two amendments. One is to provide an election for corporations to make a selection of what their base year period is.

I mention in my written remarks that we have a proposal in Massachusetts to allow a one-time election that will establish a 4-consecutive-year base period that slides anywhere from 1983 to 1995; that gets over some of the objections where companies are stuck at right now at a high base period.

Another option is to not count reductions in defense R&D spending against increases in commercial R&D spending, and there is a move away from defense-related R&D and toward commercial. To the extent that we should encourage corporations to move toward commercial, we should not count reductions in defense-related R&D against their increases in commercial.

Mr. HOOKER. Madam Chair, I disclaim expertise in the area of tax policy, but I do know that it is difficult to predict the behavioral effects of fundamental philosophical changes in tax policy, and we know that this current system works.

Mr. Ramstad asked for research evidence that indicates the macroeconomic effects of the policy. I have seen lots of research reports.

They certainly exist and are available to your staff, I am sure, so we know that the current program works.

We don't know what the effect would be of a flat tax. I think it would be risky. I would be in favor of extending the current approach.

Chairman JOHNSON. Thank you.

Mr. Olesen.

Mr. OLESEN. Well, as I said in my statement, we favor a nonincremental approach to the tax credit based on the fact that we see the need to build capacity across all of the industrial R&D sectors and to reward those people who have a long-term, steady commitment to R&D in the same fashion that we reward people who incrementally change their R&D. Overall, we believe that a nonincremental system would generate a healthier and more consistent long-term view of R&D, which again focuses on breakthrough kinds of technologies.

Ms. PENSABENE. With respect to the collaborative research credit, I think that the flat tax approach would obviously be better for us, particularly under the EPRI model.

The contributions to EPRI right now are based on gross sales from the utilities, and as I said, it is a 501(c)(3) corporation that does this research. There is only a minimal amount that we can, on a discretionary basis, increase those contributions because of the way the program is structured. A flat tax would be more appropriate with respect to this kind of collaborative research.

Thank you.

Mr. GANDHI. Incremental or flat, I think the key criterion that you want to keep in mind as you redesign a credit is to make sure that you target it properly; that is, we do not want to provide incentive to tax research that would have been done anyway. So if you want to target it and provide incentive for corporations to do more research, then incremental research is a better approach than flat credit.

The second thing you want to keep in mind here is, with all the problems that there are with incremental research, we are not saying that it is not working. All we are saying here is that there are problems that need to be fixed.

Now, as far as the flat credit is concerned, in appearance, it is quite even, uniform, and has an appeal, but it would miss the target, so that is the dilemma that we would have to resolve.

Chairman JOHNSON. Would a flat tax be easier to administer?

Mr. GANDHI. Flat would be easier, no question about that.

Chairman JOHNSON. When the Department issues its regulations, would you get back to us on whether or not they will make it easier to administer?

Mr. GANDHI. Sure.

Chairman JOHNSON. Because if it is easier to administer, it is also more secure for the companies to manage.

Mr. GANDHI. Right. I think the problem in the case of administration is more in terms of what is and what is not innovative research.

Chairman JOHNSON. I understand that, but that is pretty hard for the companies. If you are having a hard time determining that, it is very hard for them, too. I think if we want to encourage more

small and medium-sized business participation, we need to make this thing as clear and simple as we possibly can.

Mr. GANDHI. Yes.

Chairman JOHNSON. In that regard, do any of the panelists have any comments about how we could make this easier or more accessible to small businesses? Because it is true that, for the most part, it is a large business credit.

I am going to yield while you think that over. If you have any comments on that later on, please feel free to offer them. I am going to yield to my colleague, Mr. Matsui.

Mr. MATSUI. Thank you, Madam Chair. I think your question about the flat tax and the incremental approach is a very critical one.

Back in 1981 when we first discussed this issue, and we first talked about the R&D credit, it was so innovative that many were afraid that if we did it on a flat basis it would look like a corporate giveaway; and now perhaps there is some rationale to look at it in terms of—those that have long-term, continuing investments in R&D perhaps should receive it. I don't know if the budgetary problems will allow us to engage in that area, but certainly it is something that I think we should begin to talk about and consider for, if not this reference period, at least in the future.

What I would like is for all five of you, but those of you in the private sector particularly, and perhaps with other panels as well, given the fact that there is a lot of concern about the base period, the 1984–88 base period, perhaps some of you can come up with some alternatives.

I know the industry groups, the coalitions, are working on that now, but perhaps some of your individual companies can also come to us with that kind of information, so that we will have this data as we begin to come up with an alternative.

What I would like to do is to spend my moments asking Dr. Gandhi a couple of questions, because in your GAO report you indicate that the credit itself, in terms of its value, is not really determined. I read the Peat Marwick study—that was November 1994—and they go into a lot of detail and data. They basically say that the earlier studies may not have shown that the credit had real value, No. 1, because there was no study of the interaction between the credit and other provisions of the Internal Revenue Code; and No. 2, companies that began to use the credit in the early and mideighties, it took them time to adjust in terms of some of their long-term investments in research and development. So the positive attributes of the credit in the earlier years and as a result of the earlier studies may not have borne out the positive effect.

The studies in the Peat Marwick document are recent studies. They have studies by Bronwyn Hall, additional studies by Bailey and Lawrence, who were the original people that did these studies, Burger, and a number of others. I take it that your office, you, and your researchers have reviewed some of these studies and the more recent studies that they have done.

From what I understand, they have indicated that there is at least a one-for-one positive advantage in terms of, for each $1 of tax loss there is an additional $1 of R&D spending; and as I indicated in my opening statement, which I got from this document, in

the long term it would produce an additional $1, so you get two for each one; and other studies have shown even more than that.

Do you have any thoughts on that? Do you think it would be appropriate for the GAO—perhaps in the future, you can't do it in the short term necessarily, but perhaps to review some of the more recent data in this area, because it might then help update some of your analysis here, perhaps show that there is a positive value rather than uncertainty as you have in your study?

Mr. GANDHI. Right. Well, let me have two comments on that.

We have looked at some of those studies that you mentioned, sir. It all boils down to what methodology they use, what assumptions they use, and how optimistic their assumptions are. We have been very careful in making sure that we be optimistic about what are the multiplier effects, the spillover effects of the research credit; and even when we use the most optimistic assumptions, we would not be coming out with something like what has been suggested.

The Joint Committee came out yesterday with its own study on that, and we have assumed even more optimistic assumptions than what is contained in the Joint Committee.

But given all that, I do not think that we will be able to come up with that kind of projection in terms of the spillover effects. But nevertheless, we would go back and study a little more and then come back and answer you.

Mr. MATSUI. The only reason I suggest that, perhaps this is a common situation with GAO reports, but there are no references to how you arrive at some of your conclusions in here. As I mentioned, there are a number of—the Eisner study of 19—they don't have a date on here, but the earlier studies indicate there is uncertainty.

But the later studies almost all indicate it does have a positive value, and perhaps some of your research people can look at some of these later ones and then if in fact it requires a change, perhaps you might want to supplement this if it is permanent.

Mr. GANDHI. Yes, we will.

Mr. MATSUI. The only reason I ask this is because these are official documents, and obviously, I believe that they have positive value; a lot of people feel these have positive value. If in fact you can't say that, that is certainly appropriate, but if additional research would be helpful——

Mr. GANDHI. We are not saying, sir, that there is not a positive value here.

Mr. MATSUI. It is uncertain is what you are saying?

Mr. GANDHI. Exactly right. It is difficult to quantify them, difficult to identify all of them and difficult to quantify them, so we will go back and look at those studies one more time.

Mr. MATSUI. If you could look at specifically some of these studies here, I think they would bear it out.

I appreciate that very much. I have no further questions. Thank you.

[The following was subsequently received:]

Recent empirical studies cited in a report produced by KPMG Peat Marwick indicate that, in the long run, each dollar of tax credit generates two additional dollars of R&D spending. Can GAO comment on these new studies and determine if they show that the credit has positive value?

We will be issuing a report later in 1995 on our review of the new studies cited in the KPMG Peat Marwick report. Most of these new studies indicated that the amount of research spending generated by the research tax credit is larger than estimated by earlier studies. However, the authors of some of these studies, themselves, said their results should be used with caution and would benefit from further research. Our forthcoming review addresses the issue of whether these new studies provide evidence that the credit is of positive value and, more specifically, whether each dollar of credit generates an additional two dollars of research spending.

Chairman JOHNSON. Thank you. I have no further questions, either, but thank you for your testimony. I invite your input in the course of the weeks ahead. Thank you.

The next panel will consist of Kevin Conway, the director of Taxes of the United Technologies Corp.; Harry Penner, president and chief executive officer of Neurogen Corp.; Rudolph Penner, managing director of Barents Group, Peat Marwick; Douglas McPherson, director of Tax Affairs of Lockheed Martin Corp., on behalf of the Aerospace Industries Association; Charles Rau, vice president and tax counsel for MCI Communications; and Randall Capps, tax counsel and director of Federal Taxes, EDS, Plano, Tex., on behalf of the Information Technology Association of America.

If we could start right in, I would remind those testifying of the light system and invite your comments.

We will start with Mr. Conway.

STATEMENT OF KEVIN CONWAY, DIRECTOR OF TAXES, UNITED TECHNOLOGIES CORP., HARTFORD, CONN.

Mr. CONWAY. Thank you, Madam Chairman. Madam Chairman and members of the subcommittee, my name is Kevin Conway. I am the director of Taxes for the UTC, United Technologies Corp.

UTC provides a broad range of high technology products and support services for the building systems, automotive and aerospace industries. Our best known products include Pratt & Whitney jet engines, Sikorsky helicopters, Hamilton Standard aerospace systems, Otis elevators, Carrier heating and air conditioning systems, and UT automotive products.

At the end of 1994, UTC ranked 31st among the Fortune 500. We employed 171,000 people, and we were the Nation's 12th largest exporter. We are established in all but six countries of the world, giving us a uniquely global presence.

I appreciate the opportunity to testify today on this important topic. I prepared a statement which I am submitting for the record, and I would like to summarize my comments. I would also like to note that the statements I am submitting have been endorsed and supported by McDonnell Douglas Corp. and Compaq Computer Corp.

I think, Madam Chairman, to focus on some of the key points, during the period 1989–94, UTC spent an average of over $700 million per year on qualified research expenditures, or a total of $4.2 billion in that 6-year period on qualified research expenditures. However, during that period, because of the current structure of the credit, we were unable to claim $1 of research credit. The reason for that, Madam Chairman, is because the credit is not really a credit for increasing research expenditures. It started out that way, but as a result of changes over the years, the structure has been changed, so that in fact during the period 1989–94 we increased our research in certain years, but we were unable to claim the credit.

The reason for that is because, under the current formula, the requirement is that the rate of research spending increases at a greater rate than the historical rate during the period 1984–88. So the notion that the credit as currently structured rewards in-

creased research spending is not accurate. In fact, that is not the case.

The problem that we see with the structure of the current credit is that a company like United Technologies, which spends in excess—an average of $700 million a year—and by the way, I would like to point out that of that average $700 million, $400 million per year, on the average, represented salaries and wages for research jobs in the United States, and that is a key factor that has to be kept in mind.

The problem that we have with the current credit is that it is linked to the historical ratio of research expenditures to sales; and we would submit that rarely, if ever, is there any kind of a logical connection between research expenditures in the current year and sales. In fact, just the opposite is usually true. Sales today are the result of research efforts of the past. Research today is to generate sales in the future.

The problem we have is the linkage under the current structure of sales and research. In fact, if you look at the current structure, one could argue that it is really counterproductive. If your research is successful and your sales go up, your credit will either be reduced or eliminated under the current formula, and the reason for that is that your historical research spending rate is multiplied by the average of your past 4 years' sales. So if your sales increase dramatically, even if you have increased research spending, you will either lose a portion of the credit or all of it; and we don't think that makes any sense.

The other thing to keep in mind is that we should focus not only on the rate of research spending, but the absolute dollars. In today's environment, every dollar is viewed from the standpoint of efficiency and effectiveness, and R&D is no exception. By requiring an increased rate of research spending, the current tax policy is counterproductive to that.

In addition, a company like UTC and broad diversified companies—aerospace, for example, our R&D is going down while our sales remain constant. On the other hand, we have commercial businesses where our sales and our research are going up, and yet we have to average all of this together, and we are not entitled to the credit.

We believe that it is time to restructure the credit. We believe that a nonincremental flat rate credit is more appropriate in today's current economic environment, and we think that a flat rate credit in the range of 3 to 5 percent is absolutely workable.

The Joint Committee report that was released on March 28 in response to the request that you and Congressman Matsui made shows that a 3-percent flat rate credit would be revenue neutral with the current extension. It would also be possible to have a graduated credit up to 5 percent.

In terms of the issue as to—research spending, I would like to point out that a flat rate credit actually does—additional spending because the more dollars you spend in any given year, the more credit you would earn.

What we need to focus on is, we have to get away from this notion of linking sales to historical research, get away from this no-

tion of focusing on incremental dollars. Every $1 of research spending is important.

The point that Congressman Matsui made about other countries' research is critical. We at UTC compete not only with companies from these various jurisdictions, but the United States is competing for research dollars as a tax jurisdiction, so that we have Korea with a flat rate credit, R&D credit; we have Canada, our neighbors to the north; Japan, a major competitor, has a 7-percent nonincremental credit on depreciable expenditures; Spain has a 15- to 30-percent credit on nonincremental expenditures; Australia, Malaysia, and others. So in terms of looking at the need for change, we need not only to look internally, but in a global marketplace where we have to compete for research dollars.

In terms of simplification, I think the arguments there are very compelling. I can tell you that the incremental credit is extremely difficult to administer, even for a large company with a sophisticated tax department. Controversies abound with the IRS not only because of the definition, but because of the application of the base period rules, and also because when the credit is incremental it might cause the IRS to focus on the incremental expenditures. They might not audit all 700 million, just the incremental amount, and that creates some controversy.

So I think the need to go to a flat rate or nonincremental credit is compelling. It is clearly time to look at that; and I think by virtue of the fact that, as we indicated, our credit is comprised substantially of research salaries and wages, we can make a strong argument that that type of a credit will provide an incentive to maintain not only our technological base, but also high technology jobs in the United States.

Thank you for the opportunity to testify. I would be pleased to answer any questions that you may have.

[The prepared statement follows:]

Testimony by Kevin Conway
Subcommittee on Oversight
Committee on Ways & Means
House of Representatives
Proposal for Non-Incremental Research Credit

May 10, 1995

Madam Chairman and members of the Subcommittee on Oversight , my name is Kevin Conway. I am Director of Taxes for United Technologies Corporation ("UTC"). UTC provides a broad range of high-technology products and support services to the building systems, automotive, and aerospace industries. Our best known products include Pratt & Whitney military and commercial aircraft engines, Sikorsky helicopters, Hamilton Standard aerospace systems, Otis elevators and escalators, Carrier heating and air conditioning systems, and United Technologies Automotive components and systems.

At the end of 1994, UTC had 171,200 employees, including 95,200 outside of the United States. UTC is the nation's 12th largest exporter. We are ranked 31st among the Fortune 500 companies and had 1994 sales of $21.2 billion with international revenues accounting for 54 percent of the total. UTC is established in all but six of the world's countries, giving it unique global presence.

Thank you for this opportunity to testify on the subject of the research tax credit. I have a prepared statement I would like to submit for the record and I will summarize my remarks.

Background

This year, Congress will consider extending the research tax credit, which is scheduled to expire June 30, 1995. Since 1981, the Internal Revenue Code has provided a tax credit for increases in expenditures for research conducted in the United States. Congress enacted the credit because of its concern that private spending for research and experimentation had not been adequate, adversely affecting economic growth, productivity gains, and our competitiveness in world markets. It believed that a substantial tax credit for incremental research expenditures would overcome the resistance of many businesses to bear the significant costs of initiating or expanding research programs. It found that while such costs bore characteristics of investment activity, the relationships between the investment in research and the subsequent earnings often were less directly identifiable, so that many businesses were reluctant to allocate scarce investment funds for uncertain rewards. By making the credit incremental, Congress intended to maximize the credit's efficiency by not, to the extent possible, allowing credits for research that would have been undertaken in any event.

Impact of the Current Incremental Research Tax Credit

In its present form, Section 41 of the Internal Revenue Code provides for a credit equal to 20 percent of the excess of a company's qualified research expenses ("QRE") over its "base amount" for that year. The base amount is intended to approximate the amount of research that a company would undertake without the incentive of the credit. The base amount is equal to the company's ratio of QRE to gross receipts for the base period 1984-1988 (its "fixed base percentage"), multiplied by the company's average gross receipts for the four years preceding the year for which the credit is being calculated.

This formula reflects an assumption that a company's average ratio of research expense to sales in the five-year period 1984-1988 is the ratio that will always be appropriate for that company, absent a tax incentive, in every subsequent year. The ratio of research expenses to sales that makes the most sense for a company may vary from year to year, however. For instance, external business conditions may dictate a decrease in the rate of spending on research compared to sales.

Examples of such business conditions follow:

A. An aerospace company might decrease its research spending rate to reflect the expectation of reduced sales in future years resulting from increased international competition and the end of the Cold War.

B. Successful research may result in a rapid, but brief, rise in sales. During the time sales are rising at an unusually high rate, however, the company will not qualify for the credit if its research expenses do not rise at the same rate.

C. Following a period of intensive research spending, a start-up company may enter a "mature" phase when it cannot match the higher rate of spending that was required to get the business going.

D. A company may consolidate and streamline its research operations as part of a larger downsizing that is required for the company to remain competitive, but its cost-saving efforts may cause it to lose the research credit.

The incremental nature of the credit also creates a competitive disadvantage for affiliated groups of companies or a single entity which conducts different businesses. A single credit calculation must be made for such a group, treating all members of the group as a single taxpayer. That means that for a group that includes some companies whose rates of research spending, considered separately, are rising, and also includes other companies whose rates of research spending are falling, the companies with rising rates may not get any research credit because their rising rates must offset the falling rates of other companies in the group. If the companies were not affiliated, the companies with rising rates would be entitled to the credit, while the companies with falling rates would not. If one commonly-held business is an aerospace company that is decreasing its R&D expenditures relative to sales to reflect an expectation of decreased future sales, that policy, appropriate for that business, could prevent an affiliated company, in a different industry, whose rate of research spending is increasing, from receiving any incentive to further increase its spending.

Proposal for a Non-Incremental Credit

Whether or not a company is increasing or decreasing its rate of research spending relative to sales, the incentive of the research credit can be an effective way to induce that company to increase its research expenditures above the amount it would have incurred in the absence of a credit. To make the research credit as effective as possible, Congress should induce the maximum number of businesses to incur research spending, by replacing the current incremental credit with a non-incremental credit with a reduced rate. We believe that a non-incremental credit at a flat rate of 3% or a graduated rate up to 5% would not result in a significant increase in revenue cost. The Joint Committee released a report on March 28, 1995 which indicated that a non-incremental credit with a flat rate of 3% would be revenue neutral with the current incremental credit.

We recognize that giving all taxpayers the option of electing either a reduced-rate non-incremental credit or the current 20% incremental credit would result in a greater revenue loss. Because some companies have reasonably relied on the continuation of the current structure of the credit in planning for future research expenses, however, we propose that companies who have previously elected the incremental credit be given the option of continuing to claim it, with the option of electing a reduced-rate non-incremental credit. Once made, such an election would be binding for all future years.

Benefits of a Non-Incremental Credit

Providing a non-incremental credit would greatly simplify credit calculations for taxpayers, and make the Internal Revenue Service's job of auditing the credit easier. The fact that the amount of the credit depends in part on a taxpayer's gross receipts in a given year undermines the incentive effect of the credit because taxpayers cannot know in advance whether they will qualify for the credit in a given year.

Global Competition

Providing a non-incremental credit would also strengthen the ability of U.S.-based companies to compete with companies based in countries with more generous tax incentives for research. Many other countries offer credits for research expenses, some much more generous than the U.S. incremental tax credit.

Canada, for instance, offers a 20 percent non-incremental credit. The province of Quebec offers an additional 20 percent non-incremental and refundable credit for qualified wages.

Spain has offered a non-incremental credit (in addition to an incremental credit) of 15 percent for non-capital expenses and 30 percent for fixed asset acquisition expenses.

Japan provides a non-incremental credit of 7 percent for the cost of depreciable property used in basic research (subject to a limit of 15 percent of current tax, when combined with the incremental credit).

Korea provides a 5 percent non-incremental credit.

Australia allows a 150 percent deduction for research expenses.

Singapore and Malaysia allow 200 percent deductions for certain non-capital research expenses.

Several countries also offer generous incremental credits, sometimes in addition to a non-incremental credit:

France provides a 50 percent incremental credit (subject to a cap of approximately $8,250,000 per year);

Japan, a 20 percent incremental credit (subject to a cap of 10 percent of current tax) in addition to the 7 percent non-incremental credit;

Korea, a 50 percent incremental credit in addition to the 5 percent non-incremental credit;

Spain offers, in addition to its non-incremental credits, incremental credits of 30 percent for non-capital expenses and 45 percent for fixed asset acquisition expenses.

Conclusion

United Technologies' average QRE have exceeded $700 million per year during the period 1989-1994, but we have not been able to claim any research credit because of its current incremental structure. This structure significantly reduces the overall effectiveness of the research credit as an incentive to incur research expenditures and locate research facilities in this country. A non-incremental credit would encourage more companies, of all sizes and in many different industries, to retain or increase research activities in the U.S. At the same time, it would simplify the structure of the credit substantially, making it easier for more companies to claim the credit. We believe that today it is especially appropriate to consider this change to make the credit more effective because of the increasing international competition faced by many U.S.-based businesses and the increased competition for research investment by different countries. The ultimate benefit would be increased innovation and productivity in the U.S. economy, the strengthening of the U.S. technology base, and the preservation and expansion of job opportunities in this country.

Madam Chairman, I would like to state for the record that the points set forth herein are endorsed and fully supported by McDonnell Douglas Corporation and Compaq Computer Corporation.

United Technologies Corporation, McDonnell Douglas Corporation, and Compaq Computer Corporation appreciate your interest in this important issue, and I would be pleased to answer any questions.

Chairman JOHNSON. Thank you, Mr. Conway, for addressing many of the issues that we have raised to this point. I appreciate that.

Mr. Penner.

STATEMENT OF HARRY H. PENNER, JR., PRESIDENT AND CHIEF EXECUTIVE OFFICER, NEUROGEN CORP., BRANFORD, CONN., ON BEHALF OF THE BIOTECHNOLOGY INDUSTRY ORGANIZATION

Mr. HARRY PENNER. Thank you. Good morning, Madam Chairman, and members of the subcommittee. I am testifying today in support of the R&E credit both on behalf of Neurogen in Branford, Conn., and also the BIO, Biotechnology Industry Organization.

We strongly support H.R. 803, which is legislation introduced by you, Congressman Johnson, and you, Congressman Matsui, to make the R&E credit permanent. We very much appreciate the leadership you both have shown in behalf of America's research-intensive entrepreneurs, and we strongly urge the Congress to enact this legislation before the credit expires on June 30, 1995.

We also support restructuring the credit so it is available as a more effective incentive for most biotechnology companies.

Let me briefly describe Neurogen and its research and development program, then focus on our proposals to restructure the credit. Neurogen is an emerging neuropharmaceuticals company engaged in the design of breakthrough small-molecule drugs to treat a variety of neuropsychiatric disorders.

My company was formed in 1987, went public in 1989, and has grown to more than 80 employees. Some 35 percent of our employees hold doctoral degrees. We have spent more than $35 million since our founding on research. We spent $13 million on research last year. We have no product revenues, and we possibly won't have any until as late as 1999.

The drugs used currently to treat neuropsychiatric disorders are a bit like taking a shotgun to target practice. They hit the neurotransmitter, the receptor in the brain that you want to hit to improve the condition, but they also hit a variety of things around it. These are translatable readily into side effects.

Our technology, which is very novel, enables us to basically take a rifle to the receptor and not only improve the condition but virtually eliminate the possibility of side effects. In the clinic, we have patients taking a nonsedating and nonaddictive anxiolytic drug. We have in human trials a breakthrough treatment for schizophrenia, which is, we believe, going to prove free of side effects so problematic in current medications that as many as 50 percent of schizophrenic patients are not well treated; and we have a drug candidate for eating disorders.

Some 50 to 100 million people in the United States are impacted dramatically by neuropsychiatric disorders. On the one hand, we think ourselves quite special because of what we do, but on the other hand, Neurogen is really quite typical of America's 1,300 biotechnology companies. The biotech industry is the most research-intensive industry in the civilian sector.

The average biotech company spends about $68,000 per employee per year on research. My company spent over $170,000 per em-

ployee on research last year. This is many times the U.S. corporate average of $7,500 per employee. In a 1994 survey by Business Week, 6 of the top 10 firms in the United States in terms of research expenditures per employee were biotech companies.

This industry holds tremendous promise for the improved health and productivity of our citizenry. Already 27 breakthrough products have emerged from biotech R&D. Many more are in clinical trials.

The R&E credit has represented a powerful statement by the Congress in support of our work, in support of high technology in general, and in support of investment in this country's future. It also represents a significant economic incentive to our companies. But almost ironically, biotech companies tend to lose this credit just when they finally manage to bring products to the market and to generate revenue. The problem arises from the unusual economics of our industry—huge research expenditures, long development times, no revenues for many years, followed hopefully by substantial revenues. While the economics of our industry are unusual, I hope you will agree that the biotech industry is exactly the kind of research-intensive industry to which the R&E credit should apply.

We have two proposals to restructure the credit. Let me just mention them briefly. They are explained in more detail in my full statement.

No. 1, we recommend the fixed-base percentage limitations be reduced from 16 to 8 percent. No. 2, we recommend the minimum 50-percent base rule for R&E credits be eliminated. These two proposals will solve the problem with the credit; they will not create any new problems for any other industry. We don't want biotech companies like Neurogen to lose the credit just when they finally manage to bring a product to market and begin to generate revenue.

Let me summarize by stating that failure to provide viable incentives to technological advancement risks U.S. competitiveness, the viability of high technology-based businesses in this country, new jobs which are almost always higher paying—it is a higher paying end of the spectrum—future increases in taxable income, and perhaps even, most importantly, advances in the health and productivity of our citizens.

Thank you very much, and I will be happy to answer any of your questions.

[The prepared statement and attachments follow:]

TESTIMONY OF
HARRY H. PENNER, PRESIDENT AND CEO
NEUROGEN CORPORATION
ON BEHALF OF THE
BIOTECHNOLOGY INDUSTRY ORGANIZATION (BIO)
BEFORE THE OVERSIGHT SUBCOMMITTEE
HOUSE WAYS AND MEANS COMMITTEE
REGARDING THE
RESEARCH AND EXPERIMENTATION
TAX CREDIT
MAY 10, 1995

Madam Chairman and members of the Subcommittee. My name is Harry H. Penner, Jr. and I am President and CEO of Neurogen Corporation of Branford, Connecticut.

I am testifying today regarding the Research and Experimentation Tax Credit (R and E Credit) on behalf of Neurogen and the Biotechnology Industry Organization (BIO).

BIO represents more than 570 biotechnology companies, academic institutions, state biotechnology centers and related organizations in 47 states and more than 20 nations. BIO members are involved in the research and development of health care, agricultural and environmental biotechnology products.

As entrepreneurs must do, let me start with the bottom-line: we support H.R. 803, legislation introduced by Congresswoman Nancy Johnson and Congressman Robert Matsui, to make the R and E Credit permanent. We very much appreciate the leadership they have shown for America's research-intensive entrepreneurs. We urge the Congress to enact this legislation before the Credit expires on June 30, 1995. We also support restructuring the Credit so it is available as an effective incentive for most biotechnology companies.

Furthermore, we recommend that the Congress consider the R and E Credit and the Orphan Drug Tax Credit in tandem. The two Credits are interrelated; both should be made permanent and restructured. We appreciate the support which Congresswoman Johnson and Congressman Matsui have given to making the Orphan Credit permanent and restructuring it and we strongly support H.R. 1560, the bill they have introduced to this end.

Let me first talk about Neurogen and its research and development program, the R and E Credit, the biotechnology industry, and our proposals for restructuring the Credit.

Neurogen and Research and Development

Neurogen is a leading neuropharmaceuticals company engaged in the design and development of breakthrough small molecule psychotherapeutic drugs.

My company was formed in 1989, went public in 1989, and has grown to more than 80 employees, some 35% of whom hold doctoral degrees.

Our company has spent more than $35 million on research since it founding, $13 million last year alone. We have no revenue yet from product sales and do not expect any revenue from product sales until 1999. We have some revenue from other sources. We find that the R and E Credit is a tremendous incentive for investments in research.

Neurogen has integrated its proprietary understanding of neurobiology and molecular biology with cutting edge medicinal chemistry technologies to pioneer the synthesis of new generation of highly receptor specific compounds. This unique series of drug candidates promises improved treatment for a broad range of neuropsychiatric disorders, including anxiety, schizophrenia, epilepsy, dementia, depression, and sleep, eating and stress disorders. More than fifty million persons in the U.S. alone suffer from these disorders and the global market exceeding $12 billion.

Neurogen is pursuing major design and development programs based on the modulation of GABA, dopomine, and neuropeptide receptors. Using computational chemistry, the company is also developing, both for its internal use and for other biotech and pharmaceutical companies, an extensive library of high quality small molecule compounds which are designed to exhibit drug-like characteristics.

One of the molecules we have developed, NGD 91-1, has been shown to be as effective as 10 mg of Valium but with no sedation or alcohol interaction. Additional targets for this compound are dementia and sleep disorders. Another molecule, NGD 94-1, is a highly specific dopomine D4 antagonist for psychosis, or schizophrenia. We have two broad spectrum anti-psychotics, NGD 94-2 and NGD 93-1. Finally, Neurogren's neuropeptide research targets the neuropeptide associated with eating disorders, hypertension, and depression.

We are proud of the research we are doing, its importance for the well being of patients, and positive economic impact we have had on the State of Connecticut.

The R and E Tax Credit

The R and E Credit provides a 20% tax credit for qualifying research and development expenditures. It is an incremental, not a flat rate credit, and the calculation of the credit amount is complex. Not all research is included in calculation of the Credit, in fact, our industry finds that only about half of the research expenses are covered. With a 20% credit for qualified research, and at most 50% of our research covered, the true value of the credit to those companies which can claim it less than 10%.

The Orphan Credit is an alternative to the R&E Credit. Both credits are incremental credits and both are incentives for research. Firms receive only one credit for their research depending on whether it is or is not related to research on cures and therapies for "orphan" diseases or conditions (rare diseases where there is a limited patient population and limited commercial potential). The Orphan Credit is 50% for qualified research. Again, however, at most half of the research expenses are covered, and other sharp limitations apply, so the true value of the credit for the companies which can claim it is less than 25%.

We urge the Subcommittee to consider the two Credits in tandem; they are intimately related and complementary.

Economics of the Biotechnology Industry

The importance of the R and E Credit and our restructuring proposals become immediately apparent when one understands the economics of the biotechnology industry.

The biotechnology industry is one of the most research intensive industries in the civilian manufacturing sector. The average biotechnology company spends $68,000 per employee on research, more than nine times the U.S. corporate average of $7,500. In a 1994 survey by *Business Week*, six of the top ten firms in the U.S. in terms of research expenditures per employee were biotechnology companies, including Biogen ($208,724), Genentech ($117,594), and Genetics Institute ($107,657). Ernst & Young[1] reports that biotechnology companies spent $7 billion on research and development in 1994, up $1.3 billion over 1993.

Bringing a biotech drug product to the market today is both a lengthy and expensive process. From the initial testing of the drug to final approval from the Food and Drug Administration can take 7-12 years, and this process can cost anywhere from $150 to $359 million. Both the length and cost of this process are a tremendous impediment for small biotechnology companies attempting to bring a product to the market.

There are currently 28 biotechnology therapeutics and vaccines on the market. Ernst & Young reports that there are 270 in human clinical development, and over 2,000 in early research stages. As products move into clinical trails, expenses increase. The need for capital for

[1]A fiscal year for Ernst & Young is from July 1 through June 30. Therefore, 1994 indicates July 1, 1993 through June 30, 1994.

biotechnology companies to fund research is increasing right at the time when the industry is coping with a financial crisis.

The biotechnology industry experienced a net loss of $4.1 billion in 1994, and has lost over $11 billion in the last three years. In addition, biotechnology companies raised only $278 million during the first quarter 1995, compared with $762 million in the first quarter of 1994, a 63% decline.

The value of the stock of the publicly traded biotechnology companies has declined precipitously. Since January 1993 the American Stock Exchange (AMEX) biotechnology index has declined by approximately 54% and the index for biotechnology firms traded on the Chicago Board of Options Exchange (CBOE) has declined by 34%.[2] This decline over the past 28 months is due to a variety of factors, including the proposals for controls on prescription drug prices by the Clinton Administration and others during the health care reform debate, disappointments in human clinical trials, and regulatory, tax, patent and litigation issues.

A September 1994 Ernst & Young report finds that biotech companies, on average, have 25 months of capital left at their current burn rates (the rate at which capital is being expended).[3] According to a March 1994 report by Dr. Robert Goldberg of the Gordon Public Policy Center at Brandeis University, 75 percent of biotechnology companies have 2 or fewer years of capital left.[4] Ernst & Young estimates that there are 1,311 companies. If 75% have 2 or fewer years of capital left at their current burn rates, a staggering 983 companies would need to return to the market for more capital.

This capital crunch means that in the struggle to survive, companies must focus on the technology which is closest to the marketplace. They may be interested in other, longer-term projects, but they need revenue to survive. Only when they have revenue can they avoid the need to raise capital from investors.

Impact of the R and E Credit on Biotechnology Research

There can be little doubt that investment in research and development is the answer to keeping the United States economy powerful during this decade and the next century. And, surely, there can be no doubt whatsoever that America's continued economic leadership is indispensable to our national security and freedom. It is the research-driven industries which traditionally have enabled the United States to meet the rapidly intensifying industrial challenge from the rest of the world.

Biotech companies are precisely the type of companies that should be given every incentive to fully explore the technology they have invented. Such companies are beyond the start-up stage, but their revenues and corresponding research budgets are growing rapidly.

These companies are the heroes of the American private sector. If anything, they should be singled out for emulation and given added stimulation. The structure of the current R and E (and Orphan) Credit does the opposite; companies often lose the credit just when they begin to market their first products. Why take away an incentive to keep spending a large portion of revenues on research just when these companies are beginning to be successful? Why force them to reduce their research?

For the biotechnology industry to maintain its leadership in light of increased competition from Japan and Europe, the U.S. industry must compete and win in terms of research breakthroughs, which translates directly into substantial, sustained investment in research and

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[2] These percentage declines are different because these indexes include the stocks of different biotech companies. The most current figures are provided. In addition, the BioCentury 100 (TM) Indicators for a group of publicly traded biotechnology companies has declined by 40% from January 1994 through the first quarter of 1995.

[3] "Biotech 95: Reform, Restructure, and Renewal," Ninth Annual Report on the Biotechnology Industry, Ernst and Young (September 1994).

[4] "Price Controls and the Future of Biotechnology: The Results of a Survey," Dr. Robert Goldberg, Senior Research Fellow, Gordon Public Policy Center, Brandeis University (March 1994).

development. Biotechnology is barely a decade old and already it faces formidable international competition.

The fundamental purpose of the R and E Credit is to provide an incentive to private companies to conduct accelerated research -- research which will maintain our dominant position in critical industries which first emerged in the United States. After eight years of sporadic temporary measures, legislation is needed to offer a permanent tax credit for R&E activities. By its nature, R&E spending requires long-term commitment and planning. The various temporary measures in place since the previous law expired have not provided the stability needed to fully stimulate maximum research and development.

When a permanent R and E Credit is finally enacted, careful thought should be given to making the bill a complete mandate for maintaining America's leadership in vital industries. It is crucial to give the maximum incentive to emerging companies in relative new industries, such as biotechnology. In the case of biotechnology, these R&E investments will translate into dramatically improved health care for generations to come.

The R and E Credit is important to fast-growing R&E-intensive companies. For these emerging, high-growth companies, an incentive to increase investment in research and development makes the difference as to whether research projects are continued or dropped. The biotechnology industry provides a good illustration of this point.

As I have said, it takes ten to twelve years and hundreds of million dollars of R&E investment to successfully develop one new biotechnology drug. Each drug candidate faces numerous scientific and regulatory hurdles, in addition to normal competitive risks, before a biotech company can market a new prescription drug. In addition, new drugs face unprecedented price and competitive pressures due to the new health care environment. This means that a biotechnology company that is successful in commercializing its first new drug cannot sit back and enjoy its success but must continue to invest ever-increasing funds in new R&E to discover new products and grow the business. This is why the Business Week survey listed biotechnology companies as the most research-intensive companies in the country.

The need to be research intensive poses a dilemma to management. It must fund high-risk research over a long period of time while showing a profit to raise equity to fund the required R&E. This requires management to keep marketing expenses, administrative expenses, and non-research costs at an absolute minimum, as well as make difficult and painful decisions on which research projects to fund and which to drop. Given the very lean marketing and administrative levels at which these companies operate, R&E becomes the swing item in the budget. Thus management is constantly forced to drop some of its promising but higher risk projects on diseases like AIDS and breast cancer in order to meet their minimum profit targets. Once the minimum profit level is met, every additional dollar of revenue can be reinvested back in R&E.

The R and E Credit is critical to these companies. An R and E Credit directly reduces the company's tax expense and thereby increases earnings. These earnings can then be reinvested back in R&E while maintaining the company's profit level. The Credit has supported research on diseases like breast cancer, cystic fibrosis, and AIDS that would otherwise not be done. A permanent credit is particularly important to the biotech industry since its research horizons are so long term. Knowing a credit will be there for the next five years allows the companies to include it is in their long-range plan and support the continuation of high-risk projects.

Some argue that the Credit is not needed since the R&E would be done in any event. That is simply not true for the biotechnology and similar emerging research-intensive industries. It very well might make the difference between finding cures for Alzheimer's, AIDS, breast cancer, blindness and similar diseases, or not.

Restructuring the R&E Credit

BIO supports H.R. 803 and supports making the R and E Credit permanent. We also support restructuring the Credit so that most biotechnology companies qualify for it.

The problems our industry has with the current R and E Credit stem largely from the fact that the Credit is a ratio of research expenditures (the numerator) to the firm's gross receipts (the

denominator). Most biotechnology companies have no revenue, no gross receipts, but they have very large research expenditures. So, the numerator is large and the dominator is zero. As, soon as the firm begins to generate receipts, the denominator becomes a positive figure and it grossly distorts the fraction, the ratio, which determines the firm's R and E Credits.

This is a peculiar problem which does not exist for mature firms, or firms which have revenue at all times in their history. It is a unique problem which stems from the economics of our industry -- huge research expenditures, long development times, no revenues for many years, followed hopefully by revenues commensurate with the considerable risk which our investors have taken in funding the research. We believe that the economics of the biotechnology industry should be rewarded, not penalized by the R and E Credit. To avoid penalizing our industry, the Credit must be restructured.

BIO recommends that the R and E Credit be restructure in two ways:

1. Fixed-Base Percentage Limitation: The fixed base percentage limitation be reduced from 16% to 8%. The 16% maximum base percentage is the limitation on qualifying research (as a percentage of sales) which may be used to calculate the R&E Credit. Many biotech companies' research and development-to-sales ratio often exceeds 16% in their early years before the company's R&E results in a product. For these companies the 16% limitation is far too high.

As biotech companies mature and begin to generate sales, their research-to-sales ratio begins to move closer to the average for pharmaceutical companies, about 15%. This pharmaceutical average ratio is itself three times higher than the all industry average, so you can see how high the ratio is for biotech companies.

The problems with the 16% fixed base limitation is compounded by the fact that roughly 50% of a biotech company's financial statement R and D expenses do not qualify for the R&E Credit. Overhead and other costs of R and D do not qualify for the R&E Credit. A 16% limitation, therefore, requires a biotechnology company to invest over 32% of its sales in R and D (per its financial statement) to get any R&E Credit. This is clearly too high. The practical effect is that the most biotech companies will never receive an R&E Credit once they are mature, even if they invest far more revenue in R and D than any other type of company.

To correct the inequity of the current law, the 16% fixed base limitation should be reduced to 8%. This will still require biotech companies to spend at least 16% of sales on R and D in order to qualify for the R&E Credit.

2. Eliminate Minimum 50% Base Rule: The minimum 50% base rule for R&E Credits should be eliminated. It makes no sense that biotech companies which finally do qualify for the R&E Credit should be hit with a cap on their Credit.

The rule actually deters and penalizes significant growth in R&E expenditures by limiting the increment on which a credit can be given once the increment is equal to 50% of the current-year spending (or once the current year spending equals twice the baseline amount). The effect of the limitation is to bring the marginal incentive effect of the credit down from the statutory 20% to only 10%. If a company has a base of $10 million increases its R&E expenditures to $20 million, the full amount of the increase. But, if it increases its R&E expenditures to $30 million, the credit will be available only on the difference between the $30 million and the artificially assigned minimum base of $15 million, not the full increase of $20 million. This is contrary to the whole purpose of the R&E Credit.

It makes no sense to limit the credit for the firms which increase their R&E expenditures the most, but this is what the minimum 50% base rule does.

Robert Eisner, Steven Albert, and Martin Sullivan have analyzed the current R&E Credit and made some recommendations for its reform. Specifically they have suggested certain reforms which would increase the credit's effectiveness. Their first recommendation is to "eliminate the 50 percent floor to the base." They argue that, "While this limitation does not apparently relate to a large

proportion of R and D, its negative incentive effects can be considerable when it comes into play."[5]

Cost-Effectiveness of the Credit to U.S. Competitiveness

The Joint Committee on Taxation has found that making the Credit permanent will cost approximately eight billion dollars over five years. It has not yet provided estimates of the cost of these two restructuring proposals. The Credit is a sound investment for the country in the long-term competitiveness of a critical American industry.

In 1991, the Office of Technology Assessment (OTA) found that Australia, Brazil, Denmark, France, South Korea and Taiwan (Republic of China) all had targeted biotechnology as an enabling technology. Furthermore, in 1984, the OTA identified Japan as the major potential competitor to the United States in biotechnology commercialization.[6]

The OTA identified the manner in which Japan had targeted biotechnology. Its report stated,

> In 1981, the Ministry of International Trade and Industry (MITI) designated biotechnology to be a strategic area of science research, marking the first official pronouncement encouraging the industrial development of biotechnology in Japan. Over the next few years, several ministries undertook programs to fund and support biotechnology.

The Japanese Ministry of Health and Welfare instituted a policy whereby existing drugs would have their prices lowered, while allowing premium prices for innovative or important new drugs, thus forcing companies to be innovative and to seek larger markets.[7]

It is widely recognized that the biotechnology industry can make a substantial contribution to U.S. economic growth and improved quality of life. For example:

* The National Critical Technologies Panel, established in 1989 within the White House Office of Science and Technology Policy by an Act of Congress,[8] calls biotechnology a "national critical technology" that is "essential for the United States to develop to further the long-term national security and economic prosperity of the United States."[9]

* The private sector Council on Competitiveness also calls biotechnology one of several "critical technologies" that will drive U.S. productivity, economic growth, and competitiveness over the next ten years and perhaps over the next century.[10]

* The United States Congress Office of Technology Assessment calls biotechnology "a strategic industry with great potential for heightening U.S. international economic competitiveness." OTA also observed that "the wide-reaching potential applications of biotechnology lie close to the center of many of the world's major problems -- malnutrition, disease, energy availability and cost, and pollution. Biotechnology can change both the way we live and the

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[5] "The Incremental Tax Credit for R and D: Incentive or Disincentive," Robert Eisner, Steven Albert and Martin Sullivan, 37 National Tax Journal No. 2, at 181.

[6] U.S. Congress, Office of Technology Assessment, Biotechnology in a Global Economy 243 (October 1991).

[7] U.S. Congress, Office of Technology Assessment, Biotechnology in a Global Economy 244-245 (October 1991).

[8] National Competitiveness Technology Transfer Act, Pub. L. No. 101-189, 103 Stat. 1352 (42 U.S.C. §6681 et seq.).

[9] White House Office of Science and Technology Policy, Report of the National Critical Technologies Panel 7 (1991).

[10] Council on Competitiveness, Gaining New Ground: Technology Priorities for America's Future 6 (1991).

industrial community of the 21st century."[11]

* The National Academy of Engineering characterizes genetic engineering as one of the ten outstanding engineering achievements in the past quarter century.[12]

The importance of the biotechnology industry to America's competitiveness warrants making the R and E Credit permanent and restructuring it.

Detailed explanations of the fixed base limitation and minimum 50% base rule appear in the appendixes to my testimony.

Conclusion

BIO's first priority is to make the Credit permanent, but restructuring the Credit will ensure that it provides an effective incentive for research by biotechnology companies as they begin to market products, a critical time in the life cycle of a company.

BIO's proposals are for amendments to existing tax incentives, not enactment of new tax incentives. It should not be surprising that the tax code does not recognize the special strengths and needs of entrepreneurs. The tax code is old and relatively inflexible and it reflects the values of our economy as it was in the past. The problems entrepreneurs have with the tax code are similar to the problems they have with agency regulations. In both cases the terms of the law may be well intentioned, but they do not work well in the real world. BIO urges this Subcommittee to look at the tax code much as are other committees which are developing a regulatory relief program and ensure that the tax code does not unintentionally discriminate against entrepreneurs.

Thank you very much. I am ready to answer any questions you might have.

Appendixes:

Explanation of the Fixed-Base Percentage Limitation
Reducing Fixed Base Percentage Limitation from 16% to 8%
Eliminating the 50% Minimum Base Rule

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[11] U.S. Congress, Office of Technology Assessment New Developments in Biotechnology: U.S. Investment in Biotechnology-Special Report 27 (July 1988).

[12] National Academy of Engineering, Engineering and the Advancement of Human Welfare: 10 Outstanding Achievements 1964-1989 2 (1989).

Explanation of the Fixed-Base Percentage Limitation

In restructuring the R&E Credit, BIO recommends that the fixed-base percentage limitation be reduced from 16% to 8%. Following is a detailed explanation of the fixed-base limitation:

The Revenue Reconciliation Act of 1989 made some basic changes to the computation of the credit for research activities as defined in Internal Revenue Code Section 41 for taxable years beginning after 1989. For such taxable years, a 20% tax credit is available for qualified research expenditures paid or incurred in a trade or business before July 1, 1995.

The tax credit is based upon the difference between a company's qualified research expenditures for the current year over a company-specific base amount.

The fixed base percentage is a key component factor in the computation of the credit for research activities.

The **credit for research activities** is currently calculated as the sum of:

1. 20% of the increase in qualified research expenses (QRE) for the current year over a base amount, and

2. 20% of the university basic research payments.

The fixed base percentage is one of two factors used in the calculation of the **base amount.**

Base amount = fixed base percentage x average gross receipts for the four tax years preceding the credit year

The **fixed base percentage** of an existing company (except for start-ups) is a ratio. Assuming a calendar year taxpayer, the ratio would be:

Fixed base percentage = $\frac{\text{the taxpayer's aggregate QRE for 1984-1988}}{\text{aggregate gross receipts of taxpayer for same years}}$

The fixed base percentage (for non start-ups) cannot exceed 16%.

Therefore, if the computed ratio is more than 16%, the fixed base percentage "limitation" is imposed and the base amount will be calculated as 16% times the average annual gross receipts for the four tax years preceding the credit year.

Reducing Fixed Base Percentage Limitation from 16% to 8%

BIO's recommends that the 16% maximum fixed base percentage be reduced to 8% because the 16% maximum prevents certain R&E-intensive firms from receiving any R&E Credit. Following is the explanation of this recommendation.

The R&E Credit is based on increases in the amount of sales reinvested in current year "tax qualified"[1] R&E ("R&E") compared to the average amount of sales reinvested in R&E during the 1984-1988 period ("fixed base amount"). For example, if a company reinvested an average of 2%[2] of sales in tax-qualified R&E during 1984-1988, it will receive an R&E credit only if it invests more than 2% of its sales in current year R&E expenditures.

An R&E-intensive company's R&E-to-sales ratio will ' unsustainably high during its formative years as it invests in R&E in anticipation of future sales. As documented in a June 27, 1994 Business Week article, this is particularly evident in certain industries like biotech, where it can take over twenty years before a company has enough products on the market for its R&E-to-sales ratio to begin normalizing. The article lists six biotech companies as having "book" R&E-to-sales ratios of over 35% in 1993, the highest in the country. These ratios compare to the overall industrial

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1. Industrials invest approximately 2% of their sales in "tax qualified" R&E. (Tax qualified R&E excludes depreciation on R&D buildings and equipment and other expenses. It is approximately 50% of financial statement R&E.)

[2] The industrial average on a "tax qualified" R & E basis.

average of approximately 4%.

As these emerging companies become successful in developing new products, their R&E-to-sales ratios must decline and become closer to industry averages if they are to be profitable over the long term. Unless their fixed base amount is adjusted, however these R&E-intensive companies will not receive any R&E credit in future years since their future R&E-to-sales ratios will be lower than that of the 1984-88 period. This is clearly an unfair result.

To provide partial relief to early stage R&E-intensive companies, current law provides that the "fixed base amount" cannot be greater than 16%. This can be illustrated by the following example:

		1984-1988 (Average)
Sales		$25
R&E Expenses per Financials		$25
Actual % of Book R&E to Sales		100%
"Tax R&E" Eligible for Credit[1]	(A)	$12.50
% of "Tax" R&E to Sales (A/Sales)	(B)	50%
Fixed Base Amount (Lesser of B or 16%)		16%

The 16% limit is based on tax qualified R&E. Since only approximately one-half of book R&E qualifies for the R&E Credit, the 16% limit, therefore, effectively requires companies to invest over 32% of future sales in book R&E to get any credit in the future. This is an impossible base amount to exceed on a long-term basis, since the industry average is only about 4% and as shown in the Business Week survey, no industry averages over 11% on a book basis.

It is recommended that the 16% amount be reduced to 8%. The 8% amount will still require these companies to invest over 16% of sales in book R&E to be eligible for a credit. This level of R&E investment would still be more than most major R&E spenders invest, but at least would be a more reasonable "barrier" to get the credit. This can be illustrated as follows:

	Late Stage Development Company					
	8% Base			16% Base		
Sales		$100			$100	
R&E Expenses per Financials	$26			$26		
Actual % of Book R&E to Sales		26%			26%	
"Tax adjusted R&E"	$ 13	A		$13	A	
% of "Tax" R & E to Sales (A/Sales)	13%	B		13%	B	
Fixed Base Amount[4]		8%	C		16%	C
Qualifying R&E ([B-C] x A)	$5	D		$0	D	
R&E Credit (13%[3] x D)	$0.65	E		$0	E	

Eliminating the 50% Minimum Base Rule

BIO recommends that the 50% minimum base rule be eliminated. Following is a detailed explanation of the 50% minimum base rule:

The "minimum base rule" is a misnomer. The rule actually is an incremental limitation which deters and penalizes significant growth in research expenditures by limiting the increment of which a credit can be given once the increment is equal to fifty percent of current-year spending (or once the current year spending equals twice the baseline amount). the effect of the provision is to bring the marginal incentive effect of the credit down from the statutory twenty percent credit rate to only 10 percent. For example, assume a company with a base of $10 million is contemplating current-year research expenditures of $20-30 million. If the company increases its expenditures to $30 million, the credit will be available only on the difference between the $30 million and the artificially assigned minimum base of $15 million, not on the full increase of $20 million. thus, contrary to the general Congressional intent of stimulation innovation and productivity, the minimum base puts

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[1] Approximately 50% of book R & E qualifies for the credit.

[4] Assumes actual R & E to-sales ratio exceeding 16% in 1984 through 1988 period.

[3] Adjusted for Section 280C (20% vs. 65%).

constraints on those companies that want to make the greatest research efforts.

There is no policy justification for exacerbating the disincentive effect of the minimum base provisions. Many start-up and emerging growth companies would be even more adversely affected by the increased limitation than they are under the present-law rules. These smaller companies typically reinvest a significant portion of their cash in additional research. Taking away R&E Credits from these companies will make it more difficult for them to remain independent and compete in the global marketplace.

Chairman JOHNSON. Thank you for your testimony. We are pleased to have two Connecticut companies so dedicated to leadership through R&D.

Dr. Penner of Barents Group.

STATEMENT OF RUDOLPH G. PENNER, PH.D., MANAGING DIRECTOR, BARENTS GROUP, KPMG PEAT MARWICK, ON BEHALF OF WORKING GROUP ON RESEARCH AND DEVELOPMENT

Mr. RUDOLPH PENNER. Thank you, Madam Chair. I am pleased to appear before the subcommittee this morning on behalf of the Working Group on Research and Development to discuss the importance of making the R&E tax credit permanent before it expires on June 30 of this year.

It is clear that the credit is now generally regarded as an effective means of stimulating domestic R&D spending. Its effectiveness has been demonstrated by several recent independent economic studies. Nevertheless, its current temporary nature and uncertain future status make the credit less effective than if it were a permanent feature of the Tax Code. Ironically, because the Congress has extended the credit every year—albeit, sometimes retroactively—this short-term approach has yielded no reduction in the credit's actual costs; only its benefits have been reduced.

It is generally recognized that any tax incentive that is designed to encourage long-run investments will be more effective where taxpayers have some certainty regarding its continued availability. Perhaps the single most important reason why the credit has not been made permanent to date has nothing to do with the effectiveness of the credit. Rather, the key issue is revenue. A permanent extension of the credit may cost roughly $8 billion over the next 5 years according to the JCT. However, as just noted, assuming that Congress will otherwise continue to temporarily extend the credit on a short-term basis, no net revenue is actually preserved over the long term. Instead, the credit is simply made less efficient. That is, investors do not fully trust that the credit will always be available. As a result, this uncertainty is likely to lead investors to demand higher rates of return on their R&D investments than would be necessary with a permanent credit. Consequently, the periodic short-term extensions themselves impose a cost in the form of reducing the credit's effectiveness.

I would now like to turn very briefly to the key findings in a report we prepared last fall for the Working Group on Research and Development. In brief, these findings are, No. 1, that R&D is important to the Nation's long-run economic growth. In every theory of economic growth that I know, technological change is the source of a major portion of economic growth, and R&D furthers technological change or else companies would not finance it.

No. 2, there is a tendency for the private sector to underinvest in R&D. The rewards to R&D are difficult to protect using patents and other devices. Innovators are often copied. This copying increases the benefit to society but reduces the reward to the innovator. A tax credit can compensate for this failing of the marketplace.

No. 3, R&D growth has been sluggish in recent years and is lagging behind that of some of our major international competitors.

That is made clear, Madam Chair, in my full testimony in figures 1 and 3.

No. 4, evidence collected over the past several years has shown the credit to be quite effective in stimulating increased R&D spending. As has already been noted in these hearings, earlier studies did not show high effectiveness, but they didn't have much data to work with. More recent academic studies show a very high impact.

No. 5, our analysis indicates that the credit can be made more effective if permanently extended, as I have said several times. I think that point is fairly obvious. A credit that businessmen can rely on will have a much greater impact on their decision process than one that is uncertain. That is especially true when their investment decisions are made for the long run and there is already considerable uncertainty about the payoff to R&D. There is no need to add further to the risk with uncertain tax law.

Thank you very much, Madam Chairman.

[The prepared statement follows:]

STATEMENT OF RUDOLPH G. PENNER, PH.D.
MANAGING DIRECTOR, BARENTS GROUP
KPMG PEAT MARWICK
ON BEHALF OF WORKING GROUP ON RESEARCH AND DEVELOPMENT

Good morning, my name is Rudolph Penner. I am a Managing Director at Barents Group LLC, a wholly owned subsidiary of KPMG Peat Marwick LLP. I direct the Firm's practice in performing economic analysis of tax and budgetary policies. I am pleased to appear before the subcommittee this morning on behalf of the Working Group on Research and Development to discuss the importance of making permanent the research and experimentation tax credit before it expires on June 30 of this year. It is clear that the credit is now generally regarded as an effective means of stimulating domestic R&D spending. Its effectiveness has been demonstrated by several recent independent economic studies. Nevertheless, its current temporary nature and uncertain future status make the credit less effective than if it were a permanent feature of the tax code. Ironically, because the Congress has extended the credit every year (albeit sometimes retroactively), this short-term approach has yielded no reduction in the credit's actual costs — only its benefits have been reduced.

It is generally recognized that any tax incentive that is designed to encourage long-run investments will be more effective where taxpayers have some certainty regarding is continued availability. Perhaps the single most important reason why the credit has not been made permanent to date has nothing to do with the effectiveness of the credit. Rather, the key issue is revenue. A permanent extension of the credit may cost roughly $8 billion over the next five fiscal years, according to the Joint Committee on Taxation. However, as just noted, assuming the Congress will otherwise continue to temporarily extend the credit on a short-term basis, no net revenue is actually preserved over the long term. Instead, the credit is simply made less efficient. That is, investors do not fully trust that the credit will always be available. As a result, this uncertainty is likely to lead investors to demand higher rates of return on their R&D investments than would be necessary with a permanent credit. Consequently, the periodic short-term extensions themselves impose a cost in the form of reducing the credit's effectiveness.

I would now like to very briefly discuss a few of the key findings in a report we prepared last fall for the Working Group on Research and Development.[1] In brief, these are:

- R&D is important to the Nation's long-term economic growth.
- There is a tendency for the private sector to under-invest in R&D.
- R&D growth has been sluggish in recent years and is lagging behind that of some of our major international competitors.
- Evidence collected over the past several years has shown the credit to be quite effective in stimulating increased R&D spending.
- Our analysis indicates that the credit can be made more effective if permanently extended.

R&D is Important to Long-Run Economic Growth: Advances in scientific and technical knowledge are important factors explaining improvements in productivity and long-run economic growth. Innovations resulting from successful research and development (R&D) increase productivity, which contributes to increasing wages and standards of living. And,

[1] "Extending the R&E Tax Credit: The Importance of Permanence," Policy Economics Group, KPMG Peat Marwick LLP, November 1994.

numerous economic studies over the past 20 years have documented a strong link between R&D activity and productivity growth.

There is a Tendency to Under-invest in R&D: R&D activity contains a substantial "public-good" element: The benefits of R&D are not fully reflected in private rates of return, which leads to under-investment in research. Social rates of return to R&D investments are typically about twice as high on average as private rates of return. Examples of the private and social rates of return to R&D for five research-intensive industries are given in Table 1. Documented cases of a particular industry or innovation for which the social rate of return to R&D was less than the private rate of return are quite rare. The difference between the two rates of return represents the benefits to innovation that the innovator is unable to capture — typically referred to as a spillover effect: companies can often piggyback on the R&D successes of others by copying their products and production processes. The resulting competition drives down prices, which pushes the private rates of return below the social rates of return. Similarly, cost-reducing innovations in one company or industry can lead to cost reductions in other companies or industries. The existence of such spillovers implies that there is a tendency to under-invest in industrial R&D. This classic public-good problem is the fundamental justification for government intervention in the R&D market: a tax credit for R&D lowers the cost of private R&D investment, and helps to bring such investment up toward the socially desirable level.

The computer and semiconductor industries abound with examples of spillovers. The development by one manufacturer of a faster and more powerful microprocessor quickly leads to imitation by other manufacturers. Similarly, the development by one wordprocessor software company of a handy new feature — such as graphics capabilities or little buttons that automate complicated tasks — quickly leads to imitation by competitors. A similar process occurs in the pharmaceutical industry. This imitation cuts down the time period over which the original innovators can earn a return to their inventions. There are other broader kinds of spillovers, as well. The availability of increasingly inexpensive, powerful and user-friendly computers has had a broad impact on most industries — both high- and low-tech. There are a host of other more mundane innovations that have had a broad impact on society in excess of the returns to their inventors: hybridized fruits and vegetables that reduce demands on the water supply and reduce the need for pesticides; new kinds of thread that reduce the cost of textile manufacturing; new metal alloys that make cars and bicycles lighter and faster; and so on.

Table 1: Estimated Rates of Return to R&D Investments

Industry	Private Rate of Return	Social Rate of Return
Chemicals	13.3%	29.1%
Non-electrical machinery	24.0%	45.0%
Electrical products	22.4%	30.2%
Transportation equipment	11.9%	16.3%
Scientific instruments	16.1%	128.9%

Source: Jeffrey I. Bernstein and M. Ishaq Nadiri, "Interindustry R&D Spillovers, Rates of Return, and Production in High-Tech Industries," *American Economic Review Papers and Proceedings*, May 1988.

U.S. R&D Growth is Sluggish and is Lagging Our Competitors: The U.S. has not been faring well against its main competitors in terms of R&D effort. By virtue of its sheer size, the U.S. still dominates its major competitors in terms of total dollars spent on R&D. However, recent national and international trends in R&D spending show cause for concern about our continued competitiveness in research and development. First, the growth in real U.S. non-defense R&D spending has stagnated in recent years, as shown in Figure 1. The total and non-defense R&D spending growth rates are summarized in Table 2. This R&D slowdown is not due solely to the drop in federal R&D spending: real *industry-funded* R&D has shown slower growth in recent years. This is illustrated in Figure 2, which shows total U.S. R&D spending as a percentage of GDP, broken down by source of funds. Second, the U.S. is falling increasingly

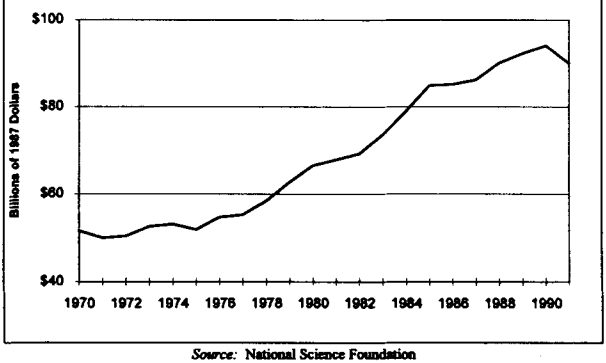
behind both Japan and Germany in terms of non-defense R&D intensity (R&D as a percentage of GDP). This trend is shown in Figure 3. In 1991, the most recent international data that we have, the U.S. spent 1.9 percent of its GDP on non-defense R&D, compared to 2.7 percent for Germany and 3.0 percent for Japan. The U.S. is gradually falling further behind: U.S. R&D intensity has remained flat since 1986, while that of Japan and Germany has continued to rise. The U.S. remains even with France (1.9 percent) and ahead of the UK (1.7), Italy (1.3), and Canada (1.4).

Table 2: Growth Rates of U.S. R&D and GDP, 1970-1991

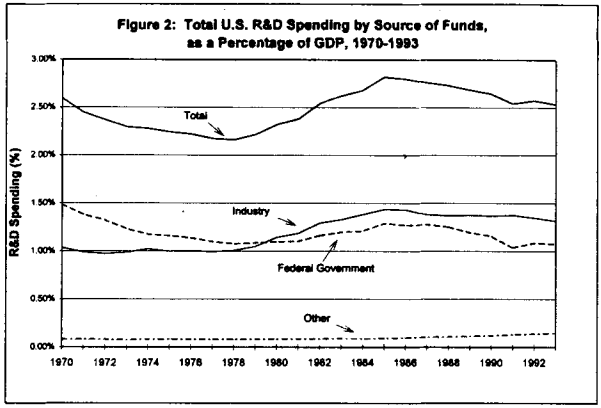
	1970-1980	1981-1990	1981-1985	1986-1990
Total R&D Growth Rate	1.6%	3.9%	6.5%	1.4%
Non-Defense R&D Growth Rate	2.5%	3.5%	4.9%	2.1%
GDP Growth Rate	2.5%	2.6%	2.5%	2.6%

Source: National Science Foundation

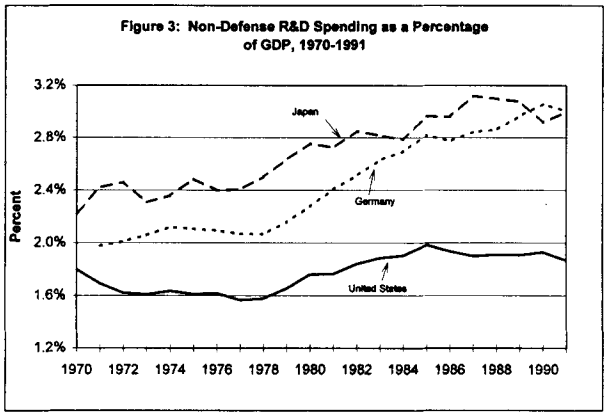
Figure 1: U.S. Constant-Dollar Non-Defense R&D Spending, 1970-1991



Source: National Science Foundation

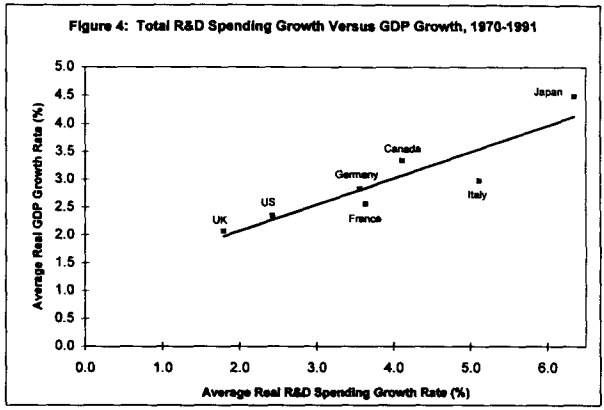


Source: National Science Foundation



Source: National Science Foundation

The importance of R&D to economic growth is illustrated in Figure 4: Across countries, faster growth in national R&D spending is generally associated with faster growth in GDP. While this diagram by itself does not demonstrate causation, several economic studies have concluded that measures of technological innovation (such as aggregate R&D spending) are important factors explaining the differences in economic growth among countries. Certainly, there are many other factors that determine an economy's growth rate, but R&D spending growth seems to be an important part of the mix.



Source: National Science Foundation

The R&E Tax Credit Has Been Quite Effective: The R&E tax credit has been shown to be effective in compensating for the tendency to under-invest in research. Several recent studies have documented the credit's effectiveness. On average, it increases R&D investment by approximately $1 for each $1 of credit in the short run, and by as much as $2 over the longer run. This evidence stands in sharp contrast to the information available in 1989, when the R&E credit underwent its last major review. As summarized in the GAO's 1989 report on the credit, early studies from the first few years of the R&E credit indicated that one dollar of foregone tax revenues only stimulated between 15 and 36 cents of additional research spending. These early studies were rather limited in that they only had available a short time-span of data to examine. They were further limited in that they did not take complete account of the interactions of the credit with other provisions of the corporate tax code. The most recent studies cover the first ten years of the credit's history and are more credible on a technical level. They indicate that the additional research spending stimulated by the credit equals or exceeds its revenue cost.

The R&E Credit Should Be Made Permanent: Making the R&E credit permanent is justified. Permanence is necessary to realize the full potential effectiveness of the R&E credit. Its effectiveness will be further enhanced if the continual uncertainty regarding its future is removed. It is important to realize that R&D funding decisions involve consideration of the long-term costs and benefits of multi-year research projects. Research plans have long horizons and long gestation periods. They are also generally risky investments — all the more so because of their long-term nature. The lack of permanence of the credit adds to the riskiness, because businessmen become more uncertain regarding the after-tax cost of R&E expenditures. Furthermore, firms appear to face longer lags in adjusting their R&D plans compared, for example, to adjusting their investments in physical capital. In the pharmaceutical and biotechnology industries, the duration of the research process itself is compounded by the lengthy process of clinical trials and FDA approval. For highly competitive industries such as computer software, electronics and semiconductors, the effects of long gestation on the R&D decision process may be compounded by relatively short pay-back periods: new products can quickly become obsolete, or must be continually improved through an on-going research program. In addition, there is some evidence in studies of the credit's effectiveness indicating lags of several years in the adjustment of companies to R&D tax incentives. This lag appears mainly to be due to the long-term nature of R&D plans.

If investors in long-term research projects cannot count on the availability of the credit over the lifetime of those investments, they will discount the future benefits that might be realized from the R&E credit and their investment levels will undoubtedly be lower than

otherwise. In fact, we have worked with some large, research-intensive companies who base their R&E investment decision on enacted law only. That is, they do not take the R&E credit into account in their investment decisions for years after the date at which the credit is scheduled to expire. Since such budgeting decisions are often made one- to two-years in advance, they have already reduced their planned R&E spending for 1995 and 1996 based on the enacted expiration of the credit as of June 30, 1995. They are engaging in less R&E spending than would be the case if future credits were assured. The more uncertain companies are about the long-term future of the credit, the smaller is its potential to stimulate increased research now and in the future. Permanence will remove that uncertainty and make the R&E credit more effective.

Chairman JOHNSON. Thank you, Dr. Penner.
Mr. McPherson.

STATEMENT OF DOUGLAS McPHERSON, DIRECTOR OF TAXES, LOCKHEED MARTIN CORP., BETHESDA, MD., ON BEHALF OF AEROSPACE INDUSTRIES ASSOCIATION OF AMERICA, INC.

Mr. MCPHERSON. Thank you, Madam Chair. My name is Doug McPherson. I am director of Taxes for Lockheed Martin Corp., which is a Maryland-based multinational, primarily engaged in the space, electronics, aeronautical, and information and technology services business, with sales to the Department of Defense comprising approximately 60 percent of its business. But I am here today representing the Aerospace Industries Association of America, Inc., which in 1994 the industry provided approximately 836,000 U.S. jobs, and certainly R&D is the lifeblood for its continued success. Rather than read the testimony, I would merely like to place it in the record and make a few comments if I could.

Chairman JOHNSON. That is fine. Thank you.

Mr. MCPHERSON. First of all, the current credit does not work for most companies in our industry. Second, making it permanent without other changes will not help most of the companies primarily doing business in the defense arena.

As you may know, the defense budget has been reduced in the last 10 years by 35 percent. More importantly, the procurement section of the defense budget has been reduced by more than 70 percent, and that is where the R&D comes from; and as I understand it, it may be further cut. Consequently, the current incremental credit denies or works against the industry as it downsizes, mergers occur, and we reengineer ourselves to conduct R&D in a more cost-effective manner.

We think the country needs to maintain its technological superiority, as was so clearly shown in the gulf war. If so, and R&D is an important part of that, the system needs to be changed to encourage more R&D, and one way is through the tax system.

As I indicated in my statement, the merger of Lockheed and Martin Marietta, which is now a $23 billion in sales company, was for the purpose of becoming more cost efficient and thus able to spend R&D moneys and other things in a more efficient manner. If you assume a similar amount is spent on R&D by the combined companies as what they spent when they were separate, more R&D will be performed, but the combined company will still not benefit from the credit. So because the incremental credit works against us, or does not help us in any event, we would recommend that taxpayers be permitted to elect a change from the current 20-percent incremental approach to a 5-percent credit on all qualified R&D expenditures; and that election could be made once every 5 years, and once it is made, it is binding for all future years.

In response to some of your previous questions, we certainly think a flat rate credit is the way to go. It benefits us. We also believe it is much simpler to administer. It is easier for the IRS to audit. If it is permanent and a flat rate, it is much easier for our people to predict what benefit it may have in the future so that you can plan, because you don't plan your research and development for only 2 months in advance; it goes out quite a ways.

So we need to have some certainty in that area. If we get that, then it permits companies to perform properly.

So I just want to thank you for the opportunity to appear before you today and welcome your support for this initiative.

[The prepared statement and attachment follow:]

STATEMENT OF DOUGLAS MCPHERSON
ON BEHALF OF AEROSPACE INDUSTRIES ASSOCIATION OF AMERICA, INC.

May 10, 1995

Introduction

My name is Douglas McPherson. I am Director of Taxes for Lockheed Martin Corporation, a Maryland-based multinational primarily engaged in the space, electronics, aeronautical, and information and technology services businesses with sales to the Department of Defense comprising approximately sixty (60%) percent of its business. I am here today representing the Aerospace Industries Association of America, Inc. (AIA).

AIA is the non-profit trade association representing the nation's manufacturers of commercial, military and business aircraft, helicopters, aircraft engines, missiles, spacecraft and related components and equipment. With a membership of more than fifty of the nation's largest manufacturers, AIA represents every significant employer in this industry.

The forces of international competition and the end of the Cold War continue to converge on the U.S. aerospace industry. Its members have been and continue to downsize - in 1994 U.S. aerospace sales fell 9 percent, investment in new plant and equipment fell 8.4 percent, employment fell 7.8 percent and industry's trade surplus fell 5.5 percent. In spite of this decline in business fortunes, the aerospace industry still remains an important segment of the U.S. economy. In 1994 it provided 836,000 U.S. jobs and $38.5 billion of exports from the U.S. Research and development (R&D) is the lifeblood for continued success of the U.S. aerospace industry. R&D is what I would like to talk about today.

The R&D Tax Credit and Its Implementation

A U.S. tax credit is currently provided under Section 41 of the Internal Revenue Code for increasing R&D expenditures on an incremental basis. Taxpayers only obtain the credit to the extent their current year's ratio of R&D expenditure to sales exceeds that same ratio for the base period 1984-1988. When calculating the current year's ratio of R&D expenditures to sales, the sales figure that must be used is the average annual gross receipts for the prior four years.

Most aerospace companies are denied the R&D credit because of the base period limitation. This limitation works against the industry in several ways.

1. As the industry downsizes, R&D as a percentage of sales is static or declining.

2. As the industry mergers occur, multiple R&D programs are being combined and economies of scale are reducing total dollars expended.

3. As the industry "re-engineers" itself to become more efficient and competitive, it is also learning to conduct R&D in a more cost effective manner.

4. As sales decline, the statutory formula for computing the ratio of current year R&D expenditures to sales is punitive.

The first three points clearly describe my own company, Lockheed Martin Corporation. The principal purpose of merging Lockheed and Martin Marietta was to create economics of scale and make the combined businesses more efficient and cost-effective. The whole idea in being more efficient is to be able to undertake more R&D. Unfortunately, the tax credit only helps if the combined company is less cost-efficient.

With respect to the fourth point, attached is a chart showing what happens to a business that grows for four years, and then suffers the nine percent annual decline in sales that the aerospace industry is facing. The business maintains its research at a constant percentage of annual sales. Because of the operation of the base period formula, this business would be entitled to an R&D credit while its overall business is growing, but would not get a credit if it suffers business declines.

Need for Change

Right when business needs to keep its R&D going, our tax policy offers no encouragement to maintains its level of R&D spending constant as a percentage of sales, let alone increase spending.

In addition to not stimulating investment in the aerospace industry, incremental credits (1) impede the orderly transition of employment from defense to commercial activities; (2) do not improve the competitiveness of the industry in world markets; and (3) discourage companies from continuing defense R&D without specific government funding.

Accordingly, the credit should provide an incentive to aerospace and other firms that conduct important research but cannot maintain the level of expenditures necessary to obtain benefits under the current incremental credit. Providing an incentive would help such firms and discourage them from moving their R&D activity offshore in search of the credits that at least sixteen other countries provide.

In calling for a change in the R&D credit, we recognize that there are a few companies for whom the present incremental credits works exactly as intended. These companies (including a few AIA members) have growing sales, and growing levels of R&D expenditures. Therefore, we are suggesting that these companies not be penalized by any changes to the existing credit.

Proposal

To accomplish the goals in this paper, AIA proposes that taxpayers should be permitted to elect to change from the current twenty percent incremental approach to a five percent credit on all qualified R&D expenditures once every five years (1995, 2000, 2005, etc.). The election, once made, would be binding for all future years.

Thank you for the opportunity to appear before you today. We appreciate the Committee's support for our industry and would welcome your support for this initiative.

Impact of Base Period and Average Sales Computation on Research Credit

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10
Sales	$1,000,000	$1,100,000	$1,210,000	$1,331,000	$1,211,210	$1,102,201	$1,003,003	$912,733	$830,587	$755,834
R&D @ 3% Of Sales	$30,000	$33,000	$36,300	$39,930	$36,336	$33,066	$30,090	$27,382	$24,918	$22,675
Average Sales Base	N/A	$1,000,000	$1,050,000	$1,103,333	$1,160,250	$1,213,053	$1,213,603	$1,161,854	$1,057,287	$962,131
Base Period @ 3%	N/A	$30,000	$31,500	$33,100	$34,808	$36,392	$36,408	$34,856	$31,719	$28,864
Increase In R&D	N/A	$3,000	$4,800	$6,830	$1,529	($3,326)	($6,318)	($7,474)	($6,601)	($6,189)
Credit @ 20%	N/A	$600	$960	$1,366	$306	$0	$0	$0	$0	$0

NOTES: First Year Credit Is Competed Under Start-Up Rules
Sales Growth at 10% Until Year 4, When They Begin to Decline at 9%

Chairman JOHNSON. Thank you very much, Mr. McPherson.
Mr. Rau.

STATEMENT OF CHARLES W. RAU, VICE PRESIDENT AND TAX COUNSEL, MCI COMMUNICATIONS CORP.

Mr. RAU. Thank you, Madam Chairman. With your permission, I would like to present only portions of my prepared statement and ask that the entire text be included in the record.

My name is Charles Rau. I am vice president and tax counsel for MCI Communications Corp., headquartered here in Washington, D.C. We have annual revenues in excess of $13 billion; we provide a wide array of consumer and business long distance services, local services, data and video communications, on-line information, electronic mail, and communications software. On behalf of both MCI and myself, I thank you, Madam Chairman, and the other members of the subcommittee for permitting me to appear before you today in support of H.R. 803.

Additionally, I express both the company's and my thanks to both you, Madam Chairman, and Mr. Matsui, for your leadership role in this very important issue.

When President Ronald Reagan signed the original R&E tax credit legislation in 1981, an avowed purpose was to stimulate a higher rate of capital formation. Recently, the House of Representatives passed major capital formation legislation, providing for the NCRS depreciation system, reduction in capital gains taxation, and creating the American dream savings accounts.

H.R. 803 addresses another critical area of capital formation, specifically the development of knowledge capital. The importance of knowledge capital was recently viewed by the Bureau of Economic Analysis of the Department of Commerce when it decided there was a need to measure the investment in our national stock of knowledge capital. The Bureau recognized that R&D expenditures are a form of investment which adds to knowledge and the development of new and improved processes and products. These, in turn, lead to increases in productivity and growth, resulting in more and better jobs and a higher standard of living for our citizens.

At MCI, since the enactment of the R&E credit in 1981, our employment has increased from 1,900 persons to 41,000. We created almost 5,000 new jobs in 1994 alone. Our investment in R&D has grown from a negligible amount in 1981 to $333 million last year. Our R&D staff has grown from none in 1981 to some 3,500 full-time people last year. While we paid a dividend representing approximately 4 percent of our earnings in 1994, in the same year 39 percent of our earnings were reinvested in research and development activities.

In the last 6 years, MCI has moved from the 17th largest international communications company in traffic volume to, now, number three. This dramatic gain is in large part attributable to MCI's cutting edge software development.

Eight years ago, for example, the National Science Foundation was able to transmit information at the rate of two pages per second. MCI has now agreed to provide transport to the National Science Foundation at the rate of two small public libraries per sec-

ond. Today, we handle 40 percent of the Internet traffic being generated by some 30 million users. A user group which, by the way, is increasing at the rate of 160,000 per month. We will soon enable the National Center for Atmospheric Research to provide instantaneous weather information to air controllers throughout the United States. These are but a few examples of the benefits from research and development in the Information Age.

Should the R&E credit be permitted to expire, our additional income tax burden would necessarily have a negative impact on our R&D budget. While I wish I were appearing before this subcommittee under circumstances which would permit me to urge you to make the R&D more generous, such as by eliminating the 50-percent minimum base rule alluded to by a prior panelist, I will not make that suggestion, given the very difficult choices which I appreciate you face in light of our current Federal budget situation.

May I conclude by indicating that I believe H.R. 803 passes the test suggested by the Speaker of the House in supporting the transformation of America from an industrial society into an Information Age society. It is consistent with the President's and Vice President's campaign document, Putting People First, where they call for a permanent extension of the R&E credit to stimulate private investment in civilian R&D. It is a concept also endorsed in the President's economic report this year and has been supported by distinguished members of this subcommittee, its chairman, and the chairman of the full House Committee on Ways and Means.

It is also consistent, I believe, with the House Republican Contract With America which states, in part, "We need to make a conscious national decision that we want to have the highest value-added jobs on the planet with the greatest productivity." Things have to be reexamined from the standpoint of what will make us the most competitive society on the planet, the best trained, and the most entrepreneurial workforce. We respectfully submit that continuation of the existing R&E credit serves our mutual goal of building a highly competitive America.

[The prepared statement follows:]

STATEMENT OF CHARLES W. RAU
VICE PRESIDENT AND TAX COUNSEL
MCI COMMUNICATIONS CORP.

My name is Charles W. Rau. I am Vice President and Tax Counsel of MCI Communications Corporation, headquartered in Washington, D.C. With annual revenue in excess of $13 billion, MCI provides a wide array of consumer and business long-distance services, local services, data and video communications, on-line information, electronic mail, network management services, and communications software.

On behalf of both myself and MCI Communications Corporation, I thank you Madame Chairman and the other members of the Subcommittee for permitting me to appear before you today in support of H.R. 803. Additionally, may I express our thanks to both you, Madam Chairman, and you, Mr. Matsui, for your leadership on this very important issue.

CAPITAL FORMATION

When President Ronald Reagan signed the original R&E tax credit legislation in 1981, an avowed purpose was to "stimulate a higher rate of capital formation." Recently, the House of Representatives passed major capital formation legislation providing for an NCRS depreciation system, a reduction in the tax on capital gains, and the creation of American Dream Savings Accounts. H.R. 803 addresses another critical area of capital formation -- specifically the development of "knowledge capital."

The importance of "knowledge capital" recently resulted in the Bureau of Economic Analysis of the U.S. Department of Commerce deciding there was a need to measure this investment in our national stock of "knowledge capital." The Bureau recognized R&D expenditures as a form of investment which adds to knowledge and to the development of new and improved processes and products. These, in turn, lead to increases in productivity and growth -- resulting in more and better jobs and a higher standard of living for our citizens.

SPILL-OVER BENEFITS

An interesting phenomenon attributable to R&D expenditures is that alluded to in both a study prepared by the Policy Economics Group of KPMG Peat Marwick and this year's Economic Report of the President. They speak of the substantial "spill-over benefits" of technological innovation. These are the benefits captured by others, without compensation to the firm making the investment. The Peat Marwick study found that these "social returns" of R&D investments are, on average, twice as high as the return obtained by the investor. The President's

Economic Report refers to estimated social returns of around 60 percent -- as compared to an average estimated return to the investor of 20 to 30 percent. The President's Report concludes that because the social return exceeds the investor's return, a private market left to its own devices would invest too little. Therefore, the Report suggests government has an important complementary role to play by sponsoring research itself, in subsidizing private sector research, or in doing both. I believe that continuing the existing R&E tax credit, has the advantage of not requiring the government to pick specific winners or losers in providing an R&D incentive. Rather, the tax credit serves as an impartial incentive to reward those who incrementally increase their expenditures on R&D projects.

In a National Bureau of Economic Research paper, Frank Lichtenberg of the Columbia Business School concluded that the rate of return on government funded R&D is less than the return on private investment -- and in some cases may even be negative.

The Peat Marwick study indicates that one dollar of R&E credit stimulates approximately one dollar of additional private R&D spending over the short run and as much as two dollars of additional R&D spending over a longer period. The President's Economic Report found that industry funded R&D investment has been noticeably greater relative to GDP during the 1980's and early 1990's than during the prior two decades. Since 1980, the Report concludes, the private sector has sponsored more R&D than has the federal government. Interestingly, this is the period during which the R&E tax credit was available.

INTERNATIONAL COMPARISONS

The Peat Marwick study concludes that, unfortunately, since 1986 the growth in non-defense R&D spending has slowed both in real dollar terms and as a percentage of GDP ("R&D intensity"). In terms of non-defense R&D intensity, this means that both Japan and Germany have increased their lead over the United States. The Economic Report of the President concluded that as a percentage of GDP, U.S. spending for civilian R&D for 1992, the most recent year for which comparative date was available, stood at 2.1 percent -- compared to 2.4 percent in Germany and 2.8 percent in Japan.

Japan provides a 20 percent tax credit for qualified R&D expenditures in excess of a base amount. Additionally, there is a 7 percent flat credit for qualifying depreciable property used in the research and development of basic technology. (It is interesting to note that a recent

newspaper article indicated that the government of Japan has projected a $585 billion multimedia market in Japan by the year 2000 -- up sharply from the $158 billion market of 1994. The article indicates this will result in the creation of 2 million new jobs.)

Germany provides investment grants and special depreciation allowances for equipment acquired for R&D purposes, in addition to the current deductibility of R&D expenses. Since 1984, Canada has provided a flat rate credit equal to 20 percent of qualified expenditures, with higher rates for smaller companies and for research in certain disadvantaged geographic areas.

MCI

Since the enactment of the R&E credit in 1981, MCI has grown its employment from 1,900 people to 41,000 people -- creating almost 5,000 new jobs in 1994, alone. Our investment in R&D has grown from a negligible amount in 1981 to $333 million in 1994. Our R&D staff has grown from none in 1981 to approximately 3,500 full time R&D professionals presently. And while we paid a dividend representing approximately 4 percent of our earnings in 1994 -- in that same year approximately 39 percent of our earnings was reinvested in research and development activities.

In the last six years, MCI has moved from the 17th largest international communications company in traffic volume to the 3rd. This dramatic gain is in large part attributable to MCI's cutting-edge software development. Eight years ago the National Science Foundation was able to transmit information at the rate of two pages per second. MCI has now agreed to provide transport to the National Science Foundation at the rate of two small public libraries per second. Today, MCI handles 40 percent of the Internet traffic being generated by its 30 million users and will soon enable the National Center for Atmospheric Research to provide instantaneous weather information to air controllers throughout the United States. These are but a few examples of the benefits derived from research and development expenditures in the Information Age.

Should the R&E tax credit be permitted to expire, MCI's additional income tax burden will necessarily have a negative impact on our R&D budget.

AN ENHANCED R&E CREDIT

While I wish I were appearing before the Subcommittee under circumstances which would permit me to urge you to make the R&E credit more advantageous -- such as by eliminating the 50 percent minimum base rule -- I will not make the suggestion given the very difficult choices which I appreciate you face in the light of our current federal budget situation.

CONCLUSION

May I conclude by indicating that I believe H.R. 803 passes the test, suggested by the Speaker, of supporting the transformation of America from an industrial society into an Information Age society. It is also consistent with the President and Vice President's 1992 campaign document, *Putting People First*, wherein they call for the enactment of a permanent extension of the R&E tax credit to stimulate private investment in civilian R&D. This concept is endorsed in this year's *Economic Report of the President* and has been supported by distinguished members of this Subcommittee, its Chairman, and the Chairman of the House Committee on Ways and Means. It is also consistent with the House Republicans' *Contract with America* which states, in part:

> "...we need to make a conscious national decision that we want to have the highest value added jobs on the planet with the greatest productivity...things have to be reexamined from the standpoint of what will make us the most competitive society on the planet...the best trained and most entrepreneurial work force...."

I respectfully submit that continuation of the existing R&E tax credit serves our mutual goal of building a highly competitive America.

Chairman JOHNSON. Thank you very much, Mr. Rau.
Mr. Capps.

STATEMENT OF R. RANDALL CAPPS, FEDERAL TAX DIRECTOR AND ASSISTANT TREASURER, ELECTRONIC DATA SYSTEMS CORP., PLANO, TEX., ON BEHALF OF INFORMATION TECHNOLOGY ASSOCIATION OF AMERICA

Mr. CAPPS. Good morning, Madam Chairwoman and members of the subcommittee. My name is Randy Capps. I am Federal tax director and assistant treasurer for the EDS, Electronic Data Systems Corp. I am here on behalf of my company and the Information Technology Association of America. I appreciate this opportunity to testify on the importance of a permanent research and experimentation tax credit.

EDS is one of the Nation's largest information technology services companies. EDS has operations in more than 40 countries and employs more than 80,000 people. With more than 6,000 direct and affiliated member companies, ITAA is the principal trade association of this Nation's computer software and services industry. It has been estimated that by the year 2000 the information technology industry will account for 14 percent of the world's GDP.

Congress created the credit to encourage the business community to conduct more research and enhance the competitive position of the United States. Despite its temporary nature, the credit has exceeded expectations. Last year, for example, every information technology services contract worldwide with a value of over $100 million was won by a U.S. firm. The R&E credit encourages business to invest in high-risk research by reducing the cost to the point where business can afford to invest scarce human and financial resources.

Ours is a research-intense economy. Total 1991 research spending in the United States was $102 billion, $78 billion of which was spent by the private sector. Among the most research intensive are information technology companies. Generally speaking, these companies spend between 4 and 5 percent of their gross receipts on qualifying R&E. Smaller entrepreneurial firms spend an even higher percentage.

These information technology companies have created thousands of high-paying, high-skilled jobs in this country and have helped U.S. companies and other industries modernize and compete more efficiently. These companies have created a host of new products and services, ranging from home banking to movies on demand to major new health care systems.

Allow me to describe the value of the credit to EDS. Since the credit was enacted in 1981, the number of EDS employees has grown from 11,000 to more than 80,000. The R&E tax credit has facilitated that growth. Our U.S. investment in research and development has grown from $15 million in 1981 to approximately $250 million in 1993. Most of our investment goes toward employee salaries.

Today, EDS is reinvesting roughly 42 percent of its domestic earnings in research and development, and the company's domestic R&D spending increased 45 percent from 1991 to 1993. With the

help of a permanent credit, R&D spending at EDS will continue to increase at a rapid pace.

The Information Age is a global phenomenon. Many of EDS's competitors are headquartered in countries with attractive tax incentives for research. Canada provides a flat rate credit equal to 20 percent of qualified research expenditures, with even higher rates for smaller companies. In France, a 50-percent incremental credit is available. Japan, Germany, and the United Kingdom likewise provide tax incentives for research. These provide our international competitors an advantage over U.S. companies, who must contend with the temporary nature of the U.S. credit.

The R&E credit has been extended six times and allowed to expire twice. Nonetheless, the credit has been successful in stimulating research. Permanent extension would make it more so.

In information technology, development cycles often far exceed the useful commercial life of a product; predictability is essential. At EDS, we educate our business units on the importance of investing in research and using the credit to reduce costs. One of the bases used to evaluate our managers is the economic value they have generated measured on an after-tax basis.

The credit is not as highly valued, however, as it would be if it were made permanent. When the investment tax credit was available, it was always considered in our formal modeling process in the decision as to whether to buy a piece of equipment. Because of its uncertain future, the R&E credit doesn't carry similar weight in determining whether to undertake risky, high-cost research projects which may take up to 200 people and 10 years to complete.

The credit provides a significant incentive for research and experimentation and is important to my industry and the economic growth of the United States. It will provide an even greater incentive if made permanent.

I appreciate the opportunity to appear before you, and I look forward to your questions.

[The prepared statement follows:]

STATEMENT OF R. RANDALL CAPPS
ELECTRONIC DATA SYSTEMS CORP., PLANO, TEX.
ON BEHALF OF INFORMATION TECHNOLOGY ASSOCIATION OF AMERICA

Good morning, Madam Chairwoman and members of the Subcommittee. My name is Randy Capps. I am Federal Tax Director and Assistant Treasurer for Electronic Data Systems Corporation (EDS). I am here today on behalf of my company and on behalf of our industry association, the Information Technology Association of America (ITAA).

I appreciate this opportunity to testify before you on the importance of the research and experimentation tax credit and the need to make it permanent.

EDS is one of the nation's largest information technology services companies, and a leader in applying information technology to meet the needs of businesses and governments worldwide. EDS has operations in more than 40 countries and employs more than 80,000 people.

ITAA is the principal trade association of this nation's computer software and services industry. Its more than 6,000 direct and affiliated member companies provide the computer software, programming, information processing, and systems integration services that make computer hardware and communications systems productive. It has been estimated that by the year 2000 the information technology industry, including consulting and telecommunications services, will account for 14 percent of the world's GDP.

I will focus my comments on the importance of the R&E Credit to my company, to the information technology industry, and the ability of U.S. companies to compete effectively in a global economy. I will also emphasize the critical need to make the Credit permanent.

I. The R&E Credit Is Important to the U.S. Economy Generally and to the U.S. Information Technology Industry In Particular

A. The R&E Credit Effectively Promotes the National Interest

Congress created the Credit for Increasing Research Activity to encourage the business community to conduct more research and enhance the competitive position of the United States in the world marketplace. Despite its temporary nature, including two lapses, the R&E Credit has exceeded expectations in meeting that objective, particularly in the information technology industry. Last year, for example, every information technology services contract -- worldwide -- with a value of over $100 million was won by a U.S. firm. Not only that, but only U.S. companies were finalists for those contracts.

Technological change and scientific advances are important factors contributing to long-term improvements in our productivity and economic growth. These, in turn, result in increased wages and improved living standards for all Americans.

As reported by Dr. Rudolph G. Penner for KPMG Peat Marwick,[1] technological innovation is a "public good," yielding "spill-over" benefits to society, not all of which

[1] Penner, Rudolph G., Smith, Linden C., and Skanderson, David M., Extending the R&E Tax Credit: The Importance of Permanence, Policy Economics Group, KPMG Peat Marwick, (November, 1994).

can be recouped by individual innovators. Indeed, according to Dr. Penner, the societal return from innovation is twice that which accrues to the individual innovator.

Although companies, particularly information technology companies, will always engage in research and experimentation, there are always more worthwhile projects than funds. Thus, promising but risky ventures must often be dropped. The R&E Credit helps overcome the understandable reluctance of business to invest in high-risk research and experimentation by reducing the cost to the point where businesses can afford to invest scarce human and financial resources.

Without the Credit, businesses have inadequate incentives to invest in the kinds of research and experimentation that yield the most social benefit. Quantifying the benefits of the Credit, Dr. Penner reports that "at the margin one dollar of R&E credit stimulates approximately one dollar of additional private R&D spending over the short run, and as much as two dollars of extra R&D over the longer-run."

B. U.S. Information Technology Leadership Is Due in Large Part to the Advances Made Possible by the R&E Credit

Ours is a research-intense economy. Total 1991 research spending in the U.S. was $102.3 billion, $78.2 billion of which was spent by the private sector.[2] Among the most research-intensive are information technology companies, particularly computer and semiconductor manufacturers and companies providing software, systems design, and computer programming services. Generally speaking, these companies spend between 5.2 percent (computers and semiconductors) and 4.3 percent (software, systems design, and computer programming) of their gross receipts on qualifying research and experimentation. Individual companies, particularly smaller, entrepreneurial firms, spend an even higher percentage.

These same information technology companies have created thousands of high-paying, high-skill jobs in this country and have helped U.S. companies in other industries modernize, increase productivity, and compete more efficiently both here and overseas. These information technology companies have also created a host of new products and services, ranging from home banking, to movies-on-demand, to major new health care systems delivering life-saving diagnostics and treatment.

None of this would have been possible without tremendous investments of time and money in research and experimentation. What is true for the information technology industry is true for other industries, such as the chemical, pharmaceutical, and automotive industries.

Without the R&E Tax Credit, U.S. information technology companies will find it much more difficult to invest large amounts of capital in long-range, high-risk programs to create innovative information technology products. Computer programs, for instance,

[2] Id. at p. 15.

typically have very short commercial life cycles before they are overtaken by technological development.

II. The R&E Credit Is Critical to EDS and Other Information Technology Companies

Allow me briefly to put into perspective the importance of the R&E Credit by describing its value to my company, EDS.

The amount of data with which businesses, governments, and individuals must deal is doubling every five years; soon, it will be every four years. EDS' strategy for dealing with this data deluge begins with consulting, whereby we help customers identify their strategic objectives and chart a course to achieve them. The next step is business process re-engineering which aligns people and processes with those objectives. EDS then designs, develops, integrates, and manages information systems to meet customer goals.

Since the Credit was enacted in 1981, the number of EDS employees has grown from 11,000 to more than 80,000. The R&E Tax Credit has facilitated that growth.

Our U.S. domestic investment in research and development[3] has grown from $15 million in 1981 to approximately $250 million in 1993, with most of that investment going toward employee salaries.

Today, EDS is re-investing roughly 42 percent of its domestic earnings in research and development, and the company's domestic R&D spending increased 45 percent from 1991 to 1993. We anticipate that, with the help of a permanent Credit, R&D spending at EDS will continue to increase at a rapid rate for the foreseeable future.

The effect of the Credit on other information technology companies is much the same. Testifying before the Senate Finance Subcommittee on Taxation and Internal Revenue Service Oversight, Cliff Simpson, Vice President, Tax, Export and Audit, for Novell indicated that his company -- a leading developer of operating systems, application software, and network services -- has grown from 14 employees in 1983 to more than 7,900. Approximately 35 percent of Novell's employees are directly involved in R&D.

III. Other Nations Have Recognized the Importance of Research and Experimentation Incentives

Information technology knows no geographic boundaries. The Information Age is a global phenomenon, and many of EDS' direct competitors are headquartered in countries that extend attractive tax incentives for research and experimentation.

With a definition of "research and experimentation" that is generally the same as ours, Canada provides a flat-rate credit equal to 20 percent of qualified research

[3] Note that for federal tax purposes, the term "research and development" is broader than "research and experimentation."

expenditures, with even higher rates for smaller companies. In addition, tax credits may offset up to 75 percent of total corporate tax liability, and certain capital expenses for scientific research are deductible.

In France, another country in which EDS faces stiff competition, a 50 percent incremental credit is available. Similarly, Japan provides a 20 percent tax credit for qualified expenditures exceeding the base amount, up to 10 percent of current tax liability. Germany and the United Kingdom likewise provide tax incentives for research and experimentation.

Designed to invigorate their indigenous technology industries and to attract foreign research initiatives, these tax incentives lower the cost of research and experimentation in these countries. They also provide our international competitors an advantage over U.S. technology companies who must contend with the uncertain, temporary nature of the U.S. R&E Credit.

IV. To Achieve Maximum Effectiveness, the R&E Credit Must Be Made Permanent

Since the R&E Credit was enacted in 1981, it has been extended six times and been allowed to expire twice, with retroactive re-enactment. Despite its uncertain and temporary character, the R&E Tax Credit has been extraordinarily successful in stimulating research and experimentation. Permanent extension, however, would make it more so, generating even higher returns to the nation.

In virtually all areas of technology, but especially in information technology, development cycles often far exceed the useful commercial life of a product. Hence, predictability is essential. Otherwise, expensive, high-risk projects of possibly major societal importance may not be undertaken. Because of the uncertainty of its long-term availability, corporate decision-makers are hesitant to consider the Credit's benefits when evaluating these risky research projects.

At EDS, we educate our business units on the importance of investing in research and the opportunities of using the Credit to reduce costs. One of the bases used to evaluate the contributions of our managers is to examine the economic value they have generated for the company, measured on an after-tax basis. The R&E Credit is thus allocated to the group that generated it, and the managers are recognized within the company for the improved performance represented by the Credit.

The R&E Credit is not as highly valued, however, as it would be were it made permanent. When the Investment Tax Credit was available, it was always considered in our formal modeling process to determine whether to buy a particular piece of equipment. Because of its uncertain future, the R&E Credit does not carry similar weight within the company in determining whether to undertake risky, high-cost research projects which can take up to 200 people and 10 years to complete.

Conclusion

The R&E Credit is important to my company, my industry, and the economic growth of the United States. Despite its uncertain availability, the Credit provides a significant incentive for research and experimentation today, and it will provide an even greater incentive if made permanent.

I appreciate this opportunity to appear before you, and I look forward to your questions. Thank you for your consideration.

Chairman JOHNSON. I thank the panel for your excellent testimony.

Dr. Rudolph Penner, in your testimony, you provide some charts—and a number of you mentioned this—that compare U.S. R&D spending growth versus R&D spending growth in other countries; and as I read your chart and your testimony, Mr. Penner, only the United Kingdom invests less in R&D. France, Italy, Canada, Germany, Japan all invest considerably more. Am I reading that correctly?

Mr. RUDOLPH PENNER. That is correct, yes.

Chairman JOHNSON. Could you elaborate a little bit on how the other countries favor R&D spending and how that compares with our tax credit, and could the panelists look at this question from the point of view of both big companies and small companies?

Mr. RUDOLPH PENNER. I think almost all of the countries on the chart have some sort of tax advantage for R&D investment. As has already been mentioned, the Japanese have a fairly generous credit. I think they have an incremental credit of, I think, 20 percent on certain kinds of expenditures. Their qualified research expenditures are defined more broadly than ours, in that a lot of the capital investment associated with R&E also gets some tax advantage.

The Canadians have a fairly generous approach to the problem. The British do, as well. I think every country recognizes that the free market, left to its own devices, would not produce enough spending on R&E investment and therefore subsidize it one way or another.

Chairman JOHNSON. Thank you. Does anyone else want to comment on foreign versus American subsidies?

Mr. CONWAY. Yes, Madam Chairman, I would just like to reemphasize that I think part of the issue—there are really two questions. In looking at the flat credit, as I testified, I think it does provide an incentive to do more research because the more dollars you spend, the greater credit you will get. There is no fixed determination year by year that a company will increase its absolute amount; but very importantly, when looking at global competition, there is a second question we now have to answer, and that is where the research will be done. From the standpoint of a tax director, doing a tax analysis in terms of looking at the tax efficiency of R&D dollars, if we look at a jurisdiction like Canada or Japan, with a flat rate credit, it is clear that in our case, for example, the research dollars spent there would be more efficient from a tax standpoint.

So we think it is time for the United States to look at these other systems—not that we have to follow them, but just to be competitive, and it makes sense now to look at this from the standpoint of restructuring our own credit to take that into account.

Chairman JOHNSON. That is exactly the point of my question, Mr. Conway. What is it about their tax law that would make your research dollar more efficient in other countries?

Mr. CONWAY. Well, I think the simple answer is that if we spend a dollar here—and as I indicated, from 1989 to 1994, we spent over $4 billion in qualified research expenditures——

Chairman JOHNSON. OK. Is the issue incremental versus flat, because if we change ours to flat does that make us competitive with them?

Mr. CONWAY. If we change ours to flat and we assume we have a choice that we can do the research in either place, we can be more tax efficient, we can reduce our Canadian taxes or our taxes in Japan by getting a flat rate credit; and that will increase our profits and make the return on research—allow us to invest more in research. So because we have a tax liability in these countries and we do business there, having a flat rate credit makes it more attractive.

I think also these other countries have simpler tax systems that can be understood. I think that is something that is unique to the U.S. system; it is very complicated and complex. I think that is also probably a factor in why they have nonincremental credits.

They also have, in some cases, dual systems. They have both.

Chairman JOHNSON. So what you are saying is that in your opinion, if we went to a flat tax, even if it were low, we would be more competitive than we are now with other countries?

Mr. CONWAY. Yes, I don't think there is any question about that.

Chairman JOHNSON. OK, other comments?

Mr. Rau.

Mr. RAU. I just wanted to say that at MCI, all of our research and development has been done, to date, in the United States under the current incremental credit.

Chairman JOHNSON. Mr. Capps.

Mr. CAPPS. Yes, at EDS, we are very aware of the different incentives for research around the world. One concern we would have is that if we didn't have extension of the research credit here, we would be at a competitive disadvantage vis-a-vis our competition.

There are foreign companies that we are in dog fights with globally, that are headquartered in these countries, that have attractive tax benefits for research. If they are getting benefits and we are not, it is going to give them a better cost structure from the bottom line than we will have.

I would like to briefly address the issue you raised earlier of the current incremental credit versus a flat credit. The current provision, as Dr. Penner indicated, seems to be working well from a macroeconomic standpoint. We find that it is working very well for the information technology industry. We do recognize that there are some pockets of legitimate concern, though, and you have already heard some of those this morning.

We would recommend, as Mr. McPherson suggested, that to the extent we try to address those concerns, we come up with elective alternatives that would take care of some of those problems, and we don't tinker with the core incremental nature of the credit, which we have already seen is working and working well.

We would be concerned if we went to a flat credit across the board and didn't have it elective. Our concern would be that you would probably have to make it so low that it wouldn't have the incentive feature that we are seeing now with the current incremental rate. I don't know just what that percentage would be.

Chairman JOHNSON. Mr. Capps, have you calculated that out in regard to your company? What would be the benefits of, say, a 5-percent flat credit? What would be your savings in terms of administration? Over time, what would be the benefits for you? I would appreciate it if you would do that.

One of the things that has concerned this subcommittee, at least rhetorically, for a number of years has been the complexity of the code; and while we have made many contributions to increase that complexity—including in the last bill that we passed—nonetheless, we are concerned about it. I appreciate Mr. Conway's point that other countries have simpler systems and that makes them more understandable, more predictable, and more manageable, and that, in and of itself, has a certain economic effect.

I would like to see if there are going to be real losers by going to a flat tax. We need to know that. If it is just anxiety about change, we need to decide whether it is worth it, but it is very hard for me to see how we restructure base years, how we restructure the rather complex nature of our current incremental system in a way that would either make it available to small companies or make it functional for many of our big companies. For example, just cutting national defense spending destroys their eligibility under this because it knocks out all defense research.

We are holding these hearings at exactly the right time because the old law is really not strong enough or thoughtful enough to meet the future. We have to think either how to change the current formula or how to just simply go to a flat, incremental tax credit. I think those of you who worry about that need to calculate it out. Those of you who have expressed anxiety about it on preceding panels, or will in later panels, need to decide whether this is just an anxiety attack about Congress and change, which would be perfectly logical—I would have anxiety attacks if I were you, if I knew that we might actually make a change that would affect you.

But I do think we have to look at the long term; and certainly our R&D investment doesn't compare favorably and our law doesn't compare favorably, and so I really urge you to look at those things from a very self-centered point of view in your industry and let us know.

[The following was subsequently received:]

EDS

May 25, 1995

The Honorable Nancy L. Johnson
U. S. House of Representatives
Room 343
Cannon House Office Building
Washington, D.C. 20515

Madam Chairwoman:

I would like to respond, for the record, to two questions you asked during my testimony before the Subcommittee on Oversight, of the Committee on Ways and Means, on May 10, 1995. You inquired as to (i) what effect a flat Research and Experimentation (R&E) Tax Credit would have on EDS and (ii) what our administrative savings would be if a change were made from an incremental to a flat credit.

EDS' R&E Credit has been averaging around 10 percent, if converted to a flat rate. This would mean a change in law from the current incremental credit to a flat credit of 5 percent would reduce our incentive by one half. In fact, anything less than a 10 percent flat credit would result in a lower incentive than we experience under current law.

The administrative savings for EDS of a change from an incremental to a flat credit would be minimal. We spend more than 2,000 hours each year identifying and documenting projects that qualify for the R&E Credit and making the required calculations. The information necessary for the incremental calculation is generally readily available, and the calculation takes a negligible amount of time. There is a requirement, however, that taxpayers who have acquired or disposed of businesses adjust their base period for those acquisitions and dispositions to keep it consistent with the current period. Since EDS has acquired a significant number of businesses, it spends about 40 hours per year making these base period adjustments. Thus, I would estimate that our administrative burden would drop by less than 2 percent (40/2,000+) if we migrated to a flat based credit. For most companies, who are not making acquisitions and dispositions, I would expect the administrative savings to be even less.

I hope the above information helps you and the rest of the Subcommittee in your analysis. I would again like to commend you for your leadership on this issue, which is so important to EDS, the information technology industry, and the country. If you have additional questions or I can be of further assistance, please feel free to phone me at (214) 605-1238. I am enclosing a copy of this letter with the corrected transcript of my testimony that I am returning to the Subcommittee.

Sincerely yours,

R. Randall Capps

R. Randall Capps

RRC:ch

Chairman JOHNSON. Mr. Matsui.

Mr. MATSUI. Thank you, Madam Chair. I am starting to think that a critical issue in this debate—and I think this issue has been kind of pending over the years, but we have never been able to really deal with it because of the revenue issue—is the issue of whether you just give a flat credit or you give an incremental credit. I noticed Ken Kaley, who has been working on this for 14 years now, sitting here and probably wondering how he is going to keep the coalition together.

I do see this, though, as a dollar-and-cents issue. You have mature companies who rightfully say that they have not had the advantage of an incremental credit—and rightfully so. Their dollars spent annually are still the same as any other company, and it has the same positive impact on a long-term/short-term GDP, the future of our country.

At the same time, I think, originally we decided to go with an incremental approach not only because of revenue issues and the fear that this would be seen as a giveaway at that time in 1981, but also because we wanted to encourage additional R&D investments by, basically, emerging companies. We have that now.

We have biotech companies, obviously communication companies; I want to ask Mr. Rau what his position is because MCI is obviously expanding rapidly. So we have this problem.

The problem, of course, with Mr. McPherson's approach—and I am not criticizing you or your approach—is you give a choice that you have a revenue problem because everybody will want to keep what they have, and then obviously you have to then provide the 3 percent, or whatever credit you give, for those that—for example, United Technologies; and somehow we have to deal with that.

You don't want to do it in a way that you reduce the amount so it is valueless to everybody because it is so minimal. We have to come to grips with it. Perhaps we want to expand the credit, spend a little bit more money on it, but I don't know if our budget will allow us to really do that.

But, Mr. Rau, could you give me your thoughts on this? MCI obviously, for 15 years now, has been a growth company, you are high technology. What would be most beneficial to you in terms of your situation at this time?

Mr. RAU. In our current situation under the incremental credit, we are very pleased with the incremental credit, the way it works, because of our rapid growth in R&D spending. To the extent additional funds are available and the Congress would want to use them to expand the credit in some elective manner, certainly we would have no objection to it. There are, of course, a variety of theories on how you might do that.

You might change the base versus a flat rate credit, and so forth, but because of our situation, I think probably somewhat similar to EDS and other information-type companies, the growth is so rapid and we put so much money into R&D and we are not a downsizing industry, we are satisfied where we are.

Mr. MATSUI. Dr. Penner, you represent generally the coalition. What are your thoughts on this between the two?

Mr. RUDOLPH PENNER. As you implied, Mr. Matsui, the coalition has not taken a position on the issue.

My personal view is that there is a difficult tradeoff here. If you do a flat tax, my understanding is that, to be revenue neutral, you would have to have a rate as low as about 3 percent, and very obviously that does not provide a very big incentive.

On the other hand, the way the current incremental credit works, it is very erratic. It is worth 13 cents on the dollar for some firms, 6.5 cents for others, nothing for many others.

I have a feeling—my own judgment is that the current approach stimulates more dollars of R&E expenditure per dollar of revenue loss. However, they are not necessarily the most efficient dollars because of the erratic nature of the credit. I think that you would probably get less R&E with a flat rate, but it would be somewhat more efficient; and judging the tradeoff between those, I think, is very difficult.

Mr. MATSUI. I appreciate that. I think that is probably a good analysis of it, because there are a lot of emerging companies that are probably going to fail, and so they are investing. Is that kind of your sense of it, they are investing R&E that may not have any value in the long term, or how do you distinguish between good R&E and not so good R&E?

Mr. RUDOLPH PENNER. Well, ultimately, you would like to measure the rate of return to it from the point of view of society as a whole, which is its impact on economic growth; and I am just making a judgment here that when you have a very erratic subsidy that provides very different kinds of subsidies to individual companies, depending on their circumstances, it is not a level playingfield, and therefore you don't get the most efficient package of R&E that you could otherwise.

Mr. MATSUI. Could I ask Mr. McPherson—you are Lockheed; is that right?

Mr. MCPHERSON. Yes.

Mr. MATSUI. Lockheed Martin.

What is your sense of this? You are a mature company. You obviously also have extensive R&E, given your international needs and the need to keep modernization going. What are your thoughts?

Mr. MCPHERSON. Well, as I indicated before, obviously, we haven't received any benefit out of the credit—most of us in the industry—probably since 1989; so, to say what is going to happen if we do get a flat rate credit, it can't do anything but help.

I don't have any macro, studies or anything on what the effect would be, but from a tax standpoint, we haven't played any role in R&D for so long that it is hard to envision. All I can say is, if we do have a flat rate credit where we get some benefit out of it, obviously we will play a role; and that will certainly, I would think, play an important part in how much more R&D is expended.

Mr. MATSUI. In other words, you think it would create an incentive effect?

Mr. MCPHERSON. I think it would help, yes.

Mr. MATSUI. Dr. Penner, I don't want to quote you because you are part of this coalition, but I know GAO would probably feel it is maybe not as great. This is something that I think all of us will have to really grapple with. I really appreciate the fact that you are all very open and candid about this, because obviously we want to work together. We want to make sure we keep the R&E; we

don't want to let this thing just deteriorate into a huge fight between industries because the long-term impact is too important to us.

I look forward to working with you, and certainly the Chair here, on this issue.

Thank you.

Chairman JOHNSON. In fact, my colleague, Mr. Matsui, has gone right to the heart of the matter that we think is very important. Erratic tax policy that affects one company one way and another company another way, in the same industry or in different industries, is not healthy, and fundamentally this does not grow a strong economy.

On the other hand, I appreciate that a 3-percent flat credit for some of you who are way out there and are in sectors where, if you are not way out there, you are not going to be there at all, does matter; and Dr. Penner, since you are really closer to a variety of these companies and are aware of these tensions, I would urge you to begin helping us look at what are the various options in a flat credit? Is there some way of recognizing certain industries in which a much higher investment of R&D is, in a sense, equivalent to a much lower investment in other segments, that the need is so much greater?

I don't know if there is any way of varying the flat credit so you have really a progressive flat credit or a variable flat credit, but it would be a lot easier, it would be a lot simpler, it would be far more equitable. I think we can't not recognize the difference in an R&D demand from one segment to another.

On the other hand, I am more concerned than I was in the beginning of this hearing, because frankly I didn't realize quite how erratic the impact of this was. I did know that some of our big companies didn't benefit at all, and the little companies were having trouble. But I think we owe it to ourselves to look at both simplicity and equity, because in the long run if we make this permanent, we are talking about tax policy for the next decade, two decades, and we ought to think about economic growth across the spectrum. So I do urge you to really give that some thought and get back to us with your best shots.

Mr. RUDOLPH PENNER. We would be very pleased to, Madam Chair.

I do think it has to be said that whatever the faults of the current approach, it is much better than the moving base that we used to have, which had some really perverse incentives in it. So there has been some improvement.

I think any incremental approach has some complexity and inefficiency involved.

Chairman JOHNSON. We are finding the same thing with retroactivity, too, and refundability.

Let me recognize Mr. Portman from Ohio.

Mr. PORTMAN. I thank the Chairwoman.

I wasn't able to be here for all your testimony. I was here earlier at the hearing and have just a continuation of the same line of questioning.

We are in this bind—Dr. Penner knows it well—on the budget; we need to figure out a way to make the Federal dollar stretch fur-

ther. It seems to me that in many of these incentives we have in our system, we need to be sure that the activity wouldn't take place otherwise.

In particular with regard to R&E, it is very important for us to figure out a way to be sure that the research and development wouldn't otherwise occur. That is why I like the incremental idea, because it seems conceptually consistent with that, that it would encourage companies to undertake additional R&E because of the Federal incentive; but I am hearing now both from reading some of your testimony and hearing from Mr. Rau and others that—and from Mr. McPherson, of course—that a flat approach might be preferable.

I guess my question for all of you, and maybe Dr. Penner, since you have already addressed this more generally, is if we do stay with an incremental-type approach, is there something that you would recommend in addition to what has already been suggested for the base period to make it more sensible?

I would agree with the Chairwoman that any time you get into the incremental approach there will be some complexity, but do you have any specific suggestions as to how the base period could be restructured? Perhaps you could start, Dr. Penner, but others chime in.

Mr. RUDOLPH PENNER. I don't, sir. I think that any change that you contemplate is going to hurt some companies and help others in the base period. That is just in the nature of how it works.

Mr. PORTMAN. But from your earlier responses, it seems to me that you do acknowledge that having a flat credit might not be consistent—and I don't mean to put words in your mouth—might not be consistent with the approach of encouraging R&E where it is not otherwise going to take place? What do you see as a middle ground between the existing system, that seems to be unfair to certain industries or businesses, and a flat rate?

Mr. RUDOLPH PENNER. As a budget person, I always think of these in a revenue-neutral kind of way, which makes it very difficult, but——

Mr. PORTMAN. Which we appreciate these days. In fact if you can think of it in terms of not just budget neutral, but a budget savings, why that would be more appreciated.

Mr. RUDOLPH PENNER. The budget neutrality requirement limits you, but I do think you gain more flexibility obviously with some sort of elective approaches and giving the companies somewhat more choice. That is a middle ground.

Mr. PORTMAN. More flexibility. Mr. Rau.

Mr. RAU. Just to clarify my earlier statement, it is that we do support an incremental credit. It has worked well for our company, and therefore all of our R&D today is done in the United States.

Mr. PORTMAN. I appreciate that. Mr. McPherson, any thoughts?

Mr. MCPHERSON. Well, I really haven't given any thought to alternatives because even if you had a sliding base scale, as our industry goes down, we still wouldn't be able to benefit from it, so it almost makes——

Mr. PORTMAN. Your industry would be unlikely to be able to take advantage of the credit with anything other than a flat rate?

Mr. MCPHERSON. Essentially.

Mr. PORTMAN. Any other thoughts?

Mr. Capps.

Mr. CAPPS. Again, the information technology industry is growing rapidly, and the current incremental credit has worked well for us. We think that from an economic standpoint, it is working, it is a good incentive, and from a macro standpoint. So we would suggest that we don't tinker with the core incremental features that we have now, but maybe provide for some elective alternatives to address some of the legitimate concerns that we have heard this morning.

Mr. PORTMAN. Thank you very much.

Mr. Conway.

Mr. CONWAY. Mr. Portman, I would just like to add, in terms of the base period, we have looked at that as an alternative, and from our standpoint, we think that for a lot of companies that is not an appropriate remedy here. The reason for that is, as long as we have a base period, you still have uncertainty. If sales increase dramatically because your R&D is successful, and you apply that base period percentage to those sales, you can lose the credit; and in terms of—we recognize also the importance of providing an incentive to do additional R&D. We recognize that that is an important policy.

I just point out that a flat rate credit can be—it could be progressive, and it certainly will provide incentive to do more in 1 year. I think those are two points that ought to be taken into account. Even a flat rate credit has incremental features or can have incremental features.

Mr. PORTMAN. To provide incentive for additional research and therefore additional credit. Thank you very much.

Thank you, gentlemen.

Chairman JOHNSON. Mr. Hancock.

Mr. HANCOCK. One of the things you need to try and do to handle all the problems, is try to figure out what Internal Revenue is going to do from year to year. I think everybody is curious about that.

I would like to see a 5-year moratorium on a lot of these rules and regulations, but I think on the question of renewal and extending the present R&D tax credit, I think the basic question is, is that going to happen? The other question is, should it be incremental or should it be a flat rate?

It would appear to me—it may have been said in early testimony, but it would appear to me, from an industry standpoint, that the most important thing would be to get a permanent extension.

Mr. RUDOLPH PENNER. I think there is no doubt about that. That is the first priority.

Mr. HANCOCK. It can work whether it is incremental or whether it is flat, but the permanent extension is the first priority. Let me ask this question then.

Would the industry consider or would they prefer even a lesser rate to get a permanent extension than the current formulas that are set up? In other words, would it be worth a little bit of a tradeoff to get a permanent extension so you could make long-term plans, even though the credit actually amounted to less money? I am not talking—20 percent less, you know.

Mr. MCPHERSON. Speaking on behalf of myself, and possibly on behalf of AIA, we recognize the problems that you people have and we would like to be flexible and work with you in that regard. Permanency is essential. Whether the rate is exactly as we ask for is another thing. I think that we should be flexible and work with you on that.

Mr. HANCOCK. I think you understand, and I support the idea of a permanent extension because I am a businessman. It drives me up the wall trying to figure out what is going to happen up here. I think the more we can get out of having to come back to Congress every year to decide whether something that you are planning on for the next 5 years is covered by the credit, and you don't know whether you can plan on it or not—it would appear to me that that would be a real detriment to even study certain programs. So I would like to hear from you all, at least some suggestions possibly for the subcommittee.

We might be able to make a more accurate recommendation that we go for a permanent extension on the basis that industry is willing to look at it, maybe the figures we are working with now would be less, in return for a permanent extension. I would appreciate any information you might be able to furnish us on that.

Mr. HARRY PENNER. I would comment that I think that there is an overall policy aspect to this credit and that is to incent high technology spending. Certainly that is the constituency I represent.

It is sort of a tradeoff we are talking about. Permanency in return for reduced credit may not necessarily get you where you want to be in terms of creating the proper incentives to maintain U.S. competitiveness in high technology, high investment industries. I think you have to consider that.

Mr. HANCOCK. I understand, but let me look at it this way. Is there a possibility, though, that there would be more overall investment in research and development from the competitive standpoint? Are there companies or businesses that are saying, well, because we don't know whether we are going to get it next year and the next year, then we are not going to do it at all? To me, that would be the key.

If I was a chief executive officer of a company, I would say, wait 1 minute, we are talking about spending $10 million in research and development partially because we are going to get a tax credit, but we can't afford to continue the program unless the Congress renews it. That is a awkward position to put any board of directors in.

Mr. HARRY PENNER. I can't deny that, but on the other hand I wonder if a one-size-fits-all policy is the correct one.

Mr. RUDOLPH PENNER. I would comment that it is right.

First of all, the uncertainty reduces the amount of R&E that you get from this credit. Logically, of course, there is some lower credit with permanency that would get you the same amount. However, I do think that the recent evidence is extremely persuasive that this is one of the most effective tax expenditures in the system in terms of bang for the buck.

So while I can't comment on specific other—I haven't done the kind of study of other kinds of tax expenditures that we have done of the R&E credit, I would suggest that when it comes to the mat-

ter of financing permanence, it would be a good idea to look down the whole list to see if there is something less effective that could be limited in order to finance permanence for this.

Mr. HANCOCK. Thank you.

Thank you, Madam Chairman.

Chairman JOHNSON. Mr. Johnson.

Mr. JOHNSON. Thank you, Madam Chairman. I think we have pretty well discussed this, and I don't want to prolong it. I would like to note that MCI and EDS are here at my suggestion, and those two companies, and I am sure the others would too, are ready to support us in any effort to devise a better tax system. Mr. Capps, in particular, is in our district in Plano, and in addition to being with EDS, was with Texas Instruments and also spent 5 years with the IRS, so I think he knows what he is talking about.

Thank you for being here.

Chairman JOHNSON. Mr. Matsui.

Mr. MATSUI. Thank you.

Mr. Penner, I didn't ask you your opinion on this difference between the incremental approach versus the flat credit approach because you represent the biotech industries. Could you tell me what your thoughts are on this and——

Mr. HARRY PENNER. It is an analysis that we personally haven't conducted at our company, but there is much more appeal to the incremental approach for our industry. We believe there are some improvements that can be made in the incremental credit, and we have suggested those and put them in the record regarding the fixed base percentage and the 50-percent base rate, and so forth. Overall, the incremental approach is one we like.

[The following was subsequently received:]

WHY AN INCREMENTAL CREDIT FOR R&E EXPENDITURES?

1) INCENTIVE THEORY

- The Research & Experimentation Tax Credit (IRC §41) was carefully crafted in the early 1980s to create an incentive for American businesses to increase the level of their expenditures directed to research and experimentation (R&E).

- In order to capture the level of year-to-year increases in R&E and base the tax credit on those increases, an incremental approach was designed.

- An incremental credit encourages new R&E, and it results in R&E that would not otherwise be conducted. Therefore, the current credit rewards those companies that increase the amount of sales revenue reinvested in R&E. In contrast, routine, recurring R&E that would be conducted anyway, is not rewarded.

- By excluding routine, recurring R&E investments, an incremental credit can be set at a high enough rate to change corporate behavior, thus generating new R&E, while still being fiscally responsible.

2) FLAT CREDIT AND "CORPORATE WELFARE"

- A shift from an incentive-based, incremental credit to a universally-available, flat credit would make the R&E credit susceptible to the charge that it is, in effect, a corporate welfare program, jeopardizing its survivability in the future.

- The main argument for a flat credit is that if high-risk, research-intensive industries, such as biotech, electronics and other cutting-edge technologies, are eligible for a tax credit, then everyone should be eligible. The proponents' preferred solution, a flat tax credit based on total R&E, clearly rewards some R&E that would be performed in any event. Service industries that routinely invest small amounts in R&E would receive the credit even though it would not incrementally increase the amount of research they perform.

3) FLAT CREDIT IS SIMILAR TO NOW-REPEALED ITC

- In 1986, Congress fundamentally reformed the tax code; included in that reform was the elimination of the Investment Tax Credit (ITC), which was a flat credit based simply on investment expenditures.

- Throughout its history, the ITC was much-maligned as nothing more than a handout to business — a tax credit for decisions businesses were going to make anyway.

- Under the intense scrutiny of the 1986 reforms, the ITC did not survive.

- Importantly, though, the incentive-based R&E credit did survive because it was structured to reward incremental research investments.

4) PERMANENCY IS MOST IMPORTANT TO BUSINESS COMMUNITY

- Business agrees that the R&E credit should be made permanent, so that investment decisions each year will be based on stability in the tax code.

- If the R&E credit is made permanent, the current incremental credit would make the difference between undertaking high-risk, long-term research projects to find cures for diseases like breast cancer or not. High-growth, R&E-intensive emerging industries, such as biotech and electronics, depend on the R&E credit to encourage these types of investments instead of safer projects.

- A wholesale change of the R&E credit may divert Congress' attention from finally making this important credit permanent.

5) BUDGET CONSTRAINTS

- Fundamentally changing the credit to a flat credit in excess of 5 percent would cost from between $5.5 to $12 billion over five years more than the current credit. These dollars would be better spent on extending the credit permanently and possibly fine-tuning the credit where needed.

- Since a flat credit would need to be set at a relatively low rate (5% or less) because of budget constraints, the effective incentive would be less than 2% on a book basis. This is hardly enough to make a difference.

- Defects in the calculation of the current credit may arguably create "winners and losers" but can be corrected (e.g., an adjustment to the base period or an election option into a progressive R&E credit at a set percentage above the national corporate R&E average) without changing the incentive nature of the R&E credit.

6) JOINT TAX COMMITTEE RATIONALE 1/

"Incremental credits are designed to target tax incentives where they have the most effect on taxpayer behavior. Incremental credits attempt to not reward projects which would have been undertaken in any event and to target incentives to marginal projects.

"Incremental credits have the potential to be far more effective per dollar of revenue cost than flat credits in inducing taxpayers to increase qualified expenditures.

"The incentive effects of incremental credits per dollar of revenue loss can be many times larger than those with a flat tax credit."

1/ Excerpts from "Description and Analysis of Certain Tax Provisions Expiring in 1994 and 1995," Joint Committee on Taxation, JSC-8-95, May 8, 1995, at pp. 38 and 39.

Mr. MATSUI. Thank you. Thank you all.

Chairman JOHNSON. I thank the panel very much. I am very pleased to have MCI and EDS here and appreciate your expertise; and Mr. Penner from the biotech industry, too. It is important that we move with good solid knowledge behind us.

I would like for you to look at your companies and see, given the administrative savings that you will make from a simpler approach, what would it take for the flat tax to be as beneficial for you as an incremental tax.

There are several ways to look at the issue of incentive. One could exclude the first 25 percent of research spending so that from then on, if you spent 10 percent additional dollars, two would go into that 25-percent base, or 250, and the rest would go into the portion that would be exposed to the flat credit.

So there are permutations that aren't quite as simple as the flat tax but have some equity and some administrative advantages. I would ask you to look at that.

I do think with the amount of activity in the small and medium-sized business sector and the role that they are increasingly playing in developing new products and doing some of the basic research that is going to drive future developments, it is important to try to think through, how can we make this more accessible to them?

To my knowledge, this isn't accessible to them. They don't have the resources to manage an incremental benefit.

Thank you very much for your testimony, and we invite your input in the weeks ahead.

[The following was subsequently received:]

BIO
BIOTECHNOLOGY
INDUSTRY
ORGANIZATION

June 6, 1995

The Honorable Nancy Johnson
Chair, Subcommittee on Oversight
House Ways and Means Committee
343 Cannon Building
Washington, D.C. 20515

The Honorable Robert Matsui
Ranking Member, Subcommittee on Oversight
House Ways and Means Committee
2311 Rayburn Building
Washington, D.C. 20515

Re: Incremental vs. Flat Rate R and E Credit

Dear Congresswoman Johnson and Congressman Matsui:

BIO very much appreciates your leadership on the R and E and Orphan Drug Tax Credits. Our entrepreneurs could not have more effective champions in the Congress.

I am writing to follow-up on issues which were raised during the testimony of Harry Penner, CEO of Neurogen, at the R and E Credit hearing. Harry was asked for his views on the comparative effectiveness of an incremental vs. a flat rate R and E Credit. Harry stated his preference for an incremental credit, but asked for the opportunity for BIO to submit additional information on the issue.

Enclosed are talking points about incremental and flat rate credits. As Harry indicated, we do prefer an incremental credit. There are some problems with the current structure of the incremental credit, which were outlined in his testimony, but these do not lead us to prefer a flat rate credit.

One of our concerns is that a flat rate credit would be subject to the same criticisms as the Investment Tax Credit, which was repealed to finance the 1986 Tax Reform law. An R and E Credit which provides a credit for the first dollar of research would be subject to the same criticism as the I.T.C. and it might lead

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to the same result. An incremental credit makes sense as it rewards increased research, not just maintenance of research effort. This design provides a true incentive for research, not a credit for research which would have been undertaken without the credit. This means that the incremental credit is designed for entrepreneurs who can increase the competitiveness of U.S. firms in international trade, a critical issue for the long-term growth of our standard of living. We are not opposed to elections which might be made available to expand the number of companies which can claim the R and E credit.

The biotechnology industry is the most research intensive industry in the civilian manufacturing sector. The industry on average spends $68,000 per employee on research, more than nine times the U.S. corporate average of $7,500. In a 1994 survey by Business Week, six of the top ten firms in the U.S. in terms of research expenditures per employee were biotechnology companies, including Biogen ($208,724), Genentech ($117,594), and Genetics Institute ($107,657). Ernst & Young reports that biotechnology companies spent $7 billion on research in 1994, up $1.3 billion over 1993. The R&E and Orphan Credits are critically important as an incentive for this research.

Thank you very much for your leadership. We will do all that we can to support making the R and E Credit and Orphan Drug Credit permanent and to restructure them so that they are even more effective for entrepreneurs.

Sincerely,

Charles E. Ludlam
Vice President for
Government Relations

CC. Ron Lefrancois
Cynthia Johnson
Members of the House Ways and Means Committee

RATIONALE FOR AN INCREMENTAL CREDIT FOR R&E EXPENDITURES

1) INCENTIVE THEORY

-- The Research & Expenditure Tax Credit (IRC S.41) was carefully crafted in the early 1980s to create an incentive for American businesses to increase the level of their expenditures directed to research and experimentation (R&E).

-- In order to capture the level of year-to-year increases in R&E and base the tax credit on those increases, an incremental approach was designed.

-- An incremental credit encourages new R&E, and it results in R&E that would not otherwise be conducted. Therefore, the current credit rewards those companies that increase the amount of sales revenue reinvested in R&E. In contrast, routine, recurring R&E that would be conducted anyway, is not rewarded.

-- By excluding routine, recurring R&E investments, an incremental credit can be set at a high enough rate to change corporate behavior, thus generating new R&E, while still being fiscally responsible.

2) FLAT CREDIT AND "CORPORATE WELFARE"

-- A shift from an incentive-based, incremental credit to a universally-available, flat credit would make the R&E credit susceptible to the charge that it is, in effect, a corporate welfare program, jeopardizing its survivability in the future.

-- The main argument for a flat credit is that if high-risk, research-intensive industries, such as biotech, electronics and other cutting-edge technologies, are eligible for a tax credit, then everyone should be eligible. The proponents' preferred solution, a flat tax credit based on total R&E, clearly rewards some R&E that would be performed in any event. Service industries that routinely invest small amounts in R&E would receive the credit even though it would not incrementally increase the amount of research they perform.

3) FLAT CREDIT IS SIMILAR TO NOW-REPEALED ITC

-- In 1986, Congress fundamentally reformed the tax code; included in that reform was the elimination of the Investment Tax Credit (ITC), which was a flat credit based simply on investment expenditures.

-- Throughout its history, the ITC was much-maligned as nothing more that a handout to business -- a tax credit for decisions businesses were going to make anyway.

-- Under the intense scrutiny of the 1986 reforms, the ITC did not survive.

-- Importantly, though, the incentive-based R&E credit did survive because it was structured to reward incremental research investments.

4) PERMANENCY IS MOST IMPORTANT TO BUSINESS COMMUNITY

-- Business agrees that the R&E credit should be made permanent, so that investment decisions each year will be based on stability in the tax code.

-- If the R&E credit is made permanent, the current incremental credit would make the difference between undertaking high-risk, long-term research projects to find cures for diseases like breast cancer or not. High-growth, R&E-intensive emerging industries, such as biotech and electronics, depend on the R&E credit to encourage these types of investments instead of safer projects.

-- A wholesale change of the R&E credit may divert Congress' attention from finally making this important credit permanent.

5) BUDGET CONSTRAINTS

-- Fundamentally changing the credit to a flat credit in excess of 5 percent would cost from between $5.5 to $12 billion over five years *more* than the current credit. These dollars would be better spent on extending the credit permanently and possibly fine-tuning the credit where needed.

-- Since a flat credit would need to be set at a relatively low rate (5% or less) because of budget constraints, the effective incentive would be less than 2% on a book basis. This is hardly enough to make a difference.

-- Defects in the calculation of the current credit may arguably create "winners and losers" but can be corrected (e.g., an adjustment to the base period or an election option into a progressive R&E credit at a set percentage above the national corporate R&E average) without changing the incentive nature of the R&E credit.

6) JOINT TAX COMMITTEE STATEMENTS[1]

-- "Incremental credits are designed to target tax incentives where they have the most effect on taxpayer behavior. Incremental credits attempt to not reward projects which would have been undertaken in any event and to target incentives to marginal projects."

-- "Incremental credits have the potential to be far more effective per dollar of revenue cost than flat credits in inducing taxpayers to increase qualified expenditures."

-- "The incentive effects of incremental credits per dollar of revenue loss can be many times larger than those with a flat tax credit."

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[1] Excerpts from "Description and Analysis of Certain Tax Provisions Expiring in 1994 and 1995," Joint Committee on Taxation, JSC-8-95, May 8, 1995, at pp. 38 and 39.

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Charles W. Rau
Vice President & Tax Counsel

May 19, 1995

The Honorable Nancy L. Johnson, Chairman
Subcommittee on Oversight
House Committee on Ways and Means
1136 Longworth House Office Building
Washington, DC 20515

Dear Madame Chairman,

This is to follow up on the questions you presented to members of our panel who testified before your Subcommittee on May 10 with respect to the R&E tax credit. I understood you to pose two questions. First, what would be the impact on our company from a change from the current 20% incremental tax credit to a flat 5% tax credit? Second, what administrative savings might be generated by a change to a flat rate tax credit?

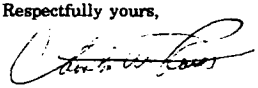
With respect to the first question, because MCI has consistently increased its commitment to research, we receive an effective tax credit of 10% of our qualified expenditures under the current incremental system. Therefore the substitution of a flat rate credit of 5% would mean a 50% reduction in the credit available to MCI. (After "the haircut" of IRC Section 280C(c)(3) the 10% becomes 6.5% -- while the 5% would become 3.25%.)

As to any administrative savings, there are fundamentally two activities connected with our obtaining the existing R&E credit. The first is the gathering of information to support the credit and the second is justifying the credit to IRS auditors during the course of their examination. In both instances, our principal administrative cost is in identifying and documenting what constitutes a qualified R&E expenditure. Any cost attendant to applying the incremental credit formula is *de minimus*. Therefore, a change to a flat rate tax credit system would generate virtually no administrative cost savings.

To the extent funds are available and you desire to make the R&E credit more universally available, we request that any enhancement be made as an elective alternative and not in lieu of the current incremental R&E tax credit.

If MCI may be of further service to you or your Subcommittee, please contact me. With our corporate headquarters in DC, we are readily available to you and your staff if further dialogue or information is desired.

Respectfully yours,



May 25, 1995

The Honorable Nancy L. Johnson
U. S. House of Representatives
Room 343
Cannon House Office Building
Washington, D.C. 20515

Madam Chairwoman:

I would like to respond, for the record, to two questions you asked during my testimony before the Subcommittee on Oversight, of the Committee on Ways and Means, on May 10, 1995. You inquired as to (i) what effect a flat Research and Experimentation (R&E) Tax Credit would have on EDS and (ii) what our administrative savings would be if a change were made from an incremental to a flat credit.

EDS' R&E Credit has been averaging around 10 percent, if converted to a flat rate. This would mean a change in law from the current incremental credit to a flat credit of 5 percent would reduce our incentive by one half. In fact, anything less than a 10 percent flat credit would result in a lower incentive than we experience under current law.

The administrative savings for EDS of a change from an incremental to a flat credit would be minimal. We spend more than 2,000 hours each year identifying and documenting projects that qualify for the R&E Credit and making the required calculations. The information necessary for the incremental calculation is generally readily available, and the calculation takes a negligible amount of time. There is a requirement, however, that taxpayers who have acquired or disposed of businesses adjust their base period for those acquisitions and dispositions to keep it consistent with the current period. Since EDS has acquired a significant number of businesses, it spends about 40 hours per year making these base period adjustments. Thus, I would estimate that our administrative burden would drop by less than 2 percent (40/2,000+) if we migrated to a flat based credit. For most companies, who are not making acquisitions and dispositions, I would expect the administrative savings to be even less.

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I hope the above information helps you and the rest of the Subcommittee in your analysis. I would again like to commend you for your leadership on this issue, which is so important to EDS, the information technology industry, and the country. If you have additional questions or I can be of further assistance, please feel free to phone me at (214) 605-1238. I am enclosing a copy of this letter with the corrected transcript of my testimony that I am returning to the Subcommittee.

Sincerely yours,

R. Randall Capps

RRC:ch

Chairman JOHNSON. The next panel consists of Dan Kostenbauder, Hewlett-Packard; Cliff Jernigan, Advanced Micro Devices; Roger Siboni, Peat-Marwick; Harry Gutman, Generic Pharmaceutical Industry Association, on behalf of the National Association of Pharmaceutical Manufacturers and National Pharmaceutical Alliance; and Gordon Steel, Xilinx.

Mr. Kostenbauder will start.

STATEMENT OF DANIEL KOSTENBAUDER, GENERAL TAX COUNSEL, HEWLETT-PACKARD CO., PALO ALTO, CALIF.

Mr. KOSTENBAUDER. Madam Chair, I am Dan Kostenbauder, general tax counsel with Hewlett-Packard Co. Last year, Hewlett-Packard had worldwide revenues of $25 billion, about 54 percent of which was outside the United States, and we spent over $2 billion worldwide in R&D.

I want to start by thanking you for conducting these hearings today on the R&E credit and express our appreciation for your leadership on this issue, along with Mr. Matsui, as leaders on H.R. 803; and to thank the other members of the subcommittee for their support of the R&E credit.

Hewlett-Packard has long supported the R&E credit, and I hope with my testimony today to add a little more insight and understanding of the workings and the mechanics of the current credit as to how it affects some companies that have been traditionally very much involved in the high technology world. The current structure of the credit does have some efficiencies that should be addressed.

The way I like to describe the current structure of the credit is to talk about R&D intensity. What happens in terms of the current credit is, you measure the qualified research and development expenses and divide that by gross receipts, the company's revenue, and that provides a fraction that was based in the 1984–88 timeframe. So your R&D divided by your revenues in that 5-year period establishes a baseline R&D intensity. Essentially, to get a credit into the future, you have to exceed that R&D intensity. If you fall below that R&D intensity, you will not get a credit.

My written statement goes into some greater detail on a variety of factors that could impact your R&D intensity over time, having more to do with many factors besides just increasing R&D.

I will focus on two particular elements that are surprising and in some ways counterproductive. For example, one is exports. If a company under this current methodology starts exporting a significant amount more than it did during the base period, this really implies that the worldwide demand is being supplied more from the United States than from outside the United States. That is not going to change the overall business R&D intensity, but reduce the R&D intensity in the United States, where we are measuring the R&E credit. So this would be one anomalous effect.

If a company started exporting significantly, it would reduce or perhaps eliminate the R&E credit because your R&D intensity would fall below the base period. That, in my view, would be a somewhat anomalous result.

Another very large factor—a number of these factors affect Hewlett-Packard and some don't that I have identified in my testimony.

The single biggest factor affecting Hewlett-Packard is the change in our business. I think it is important to note that in the high technology world, businesses are—not just computers, but even very significant parts of the computer business; for example, the economics of personal computers and the R&D intensity associated with personal computers will be different than that associated with larger computers in very substantial ways.

Let me, since I submitted my written testimony—Monday morning the Wall Street Journal had an interesting article titled "Compaq Seeks To Join U.S. Computer Industry's Elite." The point of this article is that a company which has been a leader in the personal computer area is now seeing itself as being a participant across a broader part of the computer business.

After discussing some of the issues involved in that, the reporter says, analysts also suggest Compaq will need to spend more on research and development to compete in the upper strata of computing. They define a couple of statistics about recent R&D, but then conclude, "but Compaq's outlays still amounted to only 2 percent of 1994's $10 billion-plus in sales." That compares with 6.8 of revenue at IBM, 8.1 of revenue at Hewlett-Packard, and a whopping 18 percent at Digital, all companies with much greater sales than Compaq.

I am not here to give an extensive economic analysis of all this, but what is key there is that some parts of our industry—the high technology world or the computer world, broadly defined—have a historical business with a very low R&D intensity associated with it and others have much higher R&D intensity.

Some of those companies do nothing more than change their business mix and therefore have a higher R&D intensity and will get a very large R&E credit. Other companies who are changing their business mix and having more sales of products with lower R&D intensity are virtually precluded in the future from getting an R&E credit, and this is an anomaly that we think should have been addressed in any extension of the R&E credit.

One other thing. If you have my written testimony, there is a chart on the last page that is helpful in understanding what is happening, by referring to that chart. Three lines, the top line being revenue, if you have a successful company where revenue is increasing because of this phenomenon of R&D intensity being the same, the bottom line is the base, and that will increase along with revenue.

So for any number of these reasons I have talked about, if R&D is actually growing at a slower rate than revenue is growing, over time that company will be out of the R&E credit despite the many different factors that could cause that result.

In conclusion, I would like to strongly urge the subcommittee to improve the base period. Particularly if some low-cost solution to improving the credit can be identified, it should definitely be adopted in conjunction with a permanent extension of the credit.

Thank you, Madam Chair.

[The prepared statement and attachment follow:]

STATEMENT OF DANIEL KOSTENBAUDER
GENERAL TAX COUNSEL, HEWLETT-PACKARD CO.
PALO ALTO, CALIF.

Good morning. My name is Dan Kostenbauder. I am General Tax Counsel at Hewlett-Packard Company of Palo Alto, California. I appreciate the opportunity to testify today on behalf of Hewlett-Packard Company about the need for restructuring of the base period rules for the research and experimentation (R&E) credit.

Madam Chairman, I want to congratulate you and Mr. Matsui, the Ranking Member of the Oversight Subcommittee, for your leadership in introducing H.R. 803. Although my testimony will discuss the need for modifications to the structure of the R&E credit, your bill is an excellent starting point. We appreciate that you are holding hearings on the need for a permanent R&E credit and to examine possible structural modifications to ensure that the R&E credit delivers the maximum incentive effect to the largest number of taxpayers possible. We would also like to express our appreciation, as well, for the support of the many co-sponsors of H.R. 803 -- both in the Ways and Means Committee and the full House of Representatives.

Hewlett-Packard designs, manufactures and services electronic products and systems for measurement, computation and communications. Our basic business purpose is to create information products that accelerate the advancement of knowledge and improve the effectiveness of people and organizations. The company's products and services are used in industry, business, engineering, science, medicine and education in more than 120 countries.

During HP's last fiscal year, which ended October 31, 1994, HP had worldwide revenues of about $25 billion. Over 54% of this revenue was from sales to customers outside of the United States. HP spent over $2 billion on research and development worldwide, most of which was performed within the United States. HP's strong research and manufacturing base in the United States enables it to be one of our country's largest exporters. Last year HP exported over $4.6 billion from the United States.

Research and development have long been key to the success of HP and other high-technology companies. The process of developing new high-technology products is complex and uncertain and requires innovative designs that anticipate customer needs and technological trends. After the products are developed, the company must quickly manufacture products in sufficient volumes at acceptable costs to meet demand.

During the 14 years that the R & E credit has been in effect, HP has increased qualified R & E every year except one. Since the R&E credit was first adopted in 1981, there has been an ongoing debate -- in Congress and in the business community -- about whether it is appropriate to have an R&E credit, and if so, how it should be structured. When the R&E credit was first enacted, it was made temporary so that Congress could judge its effectiveness. Since then it has been extended six times. Congress has consistently reaffirmed its commitment to provide a market incentive to encourage private-sector R&D.

HP has supported tax incentives for R&D since 1981. We believe that R&D is a high value-added activity that generates good, high-wage jobs and a better standard of living. Increasing R & D in the United States will lead to a stronger U. S. economy as the technology and intellectual property generated by R&D is sold in the global marketplace. Tax incentives to stimulate U. S. R & D are appropriate because they will increase U. S. economic growth and counteract the incentives many other countries offer for conducting R & D in their countries.

The R&E credit's focus has been sharpened by limiting both qualifying activities and eligible expenditures, and altering its computational mechanics. The credit has been the focus of significant legislative activity and has undergone refinement many times since its inception. Accordingly, such an important incentive must be continually reviewed to ensure that it is structured so that it is available over time to companies that effectively commercialize R & D.

Most companies that conduct a significant amount of R&D in the United States sell a significant amount outside of the United States. In HP's case about 54% of total worldwide revenue is from customers outside of the United States. For a company to be successful, it is critical to sell into the global marketplace in order to be able to achieve the highest possible revenue from a given expenditure for R&D. In global business, being able to keep global R&D intensity as low as possible by maximizing revenue is a critical competitive element. If a company's R&D expenses

are much higher than those of direct competitors, company profits available to finance future R&D and general growth will not be as readily available.

"RESEARCH INTENSITY" CREDIT

The 1989 revision of the methodology for computing the R&E credit measures R&E intensity (Qualified R&E divided by gross receipts) during an arbitrary 5-year base period (1984-1988). To the extent R&D intensity increases, a credit is available. If R&D intensity falls, then no credit is available. For purposes of this computation, gross receipts are measured using a four-year moving average. This is an appropriate element of the formula, since companies generally would find it difficult, and probably imprudent, to increase R&D expenses to correspond with revenue growth above expected levels. Furthermore, if gross receipts were measured on only a current year basis, the amount of R&E credit could be very volatile and therefore would be less of an incentive. In addition, companies that are especially successful in commercializing R&D would almost never be able to increase R&D above the base period intensity level if gross receipts were measured using too short a time period.

The "R & D intensity" methodology has an underlying premise that higher gross receipts enable a company to spend a proportionately higher amount on R & D. This premise might have some validity if a company maintained the same relative mix of products and the same relative market position and if the economics and technologies of those products remained stable over time. In rapidly changing high-technology businesses, these circumstances are unlikely to prevail for very long for very many companies.

CONCERNS ABOUT THE "RESEARCH INTENSITY" CREDIT

At the end of this testimony is a chart that schematically addresses HP's main concern with the "research intensity" R & E credit methodology.

Any company whose rate of revenue growth exceeds its rate of R & E growth will eventually receive no incentive from the U. S. R & E credit -- *even though the company's R&E is increasing.* This is a result that should not be built into the structure of the credit without some feature to permit companies whose base exceeds qualified R & E, while qualified R & E is increasing, to qualify for the credit.

R & D expense budgets are much more within the control of a company's management than gross receipts. Gross receipts will depend on how quickly, cheaply and effectively a company can manufacture and sell products it has invented and designed. Ultimately gross receipts will depend upon how customers react to the fruits of the R & D effort -- will they pay high prices for large quantities of a product, or will they only be willing to buy small quantities at low prices? Companies and their management's can decide to spend a certain amount on R & D, but they cannot control how customers respond. Companies that consistently, over a number of years, are able to convert R & D spending into successful products will have their gross receipts grow faster than R & D in most cases.

Having a changing mix of products is another major factor that can result in a company having gross receipts grow faster than R & E expenses. To illustrate this point, imagine a company that was in a business characterized by high R & E intensity (say 14%) during the 1984-1988 base period. Suppose that the company decides to compete in a second high-technology business characterized by somewhat lower R & E intensity (say 8%). If the company is successful in the second business, its future R & E intensity for the two businesses together will be lower than the company's "fixed base percentage." This would be true even if the company increased the R & E intensity of its new business (to 10%). Again, given the dynamic nature of most companies, fixing the appropriate threshold for determining R & E credits on a base period 7 to 11 years prior to today, without any adjustment mechanism, seems quite inappropriate.

FACTORS THAT AFFECT R&E INTENSITY

For analytical purposes, it is useful to consider a company's R & E intensity on a global basis, since most high-technology companies compete in a worldwide marketplace. Global R&D intensity may be considered to be composed of U.S. R&D intensity and foreign R&D intensity.

The mechanics of the U.S. R&E credit will then be affected by three major factors:
(1) U.S. R&E intensity during the 1984-1988 base period, which established the "fixed base percentage;"
(2) factors impacting general R&E intensity; and
(3) factors impacting only U.S. R&E intensity.

FIXED BASE PERCENTAGE

The 1984-1988 period used to establish the "fixed base percentage," which can be thought of as "R&E intensity," is obviously an arbitrary period. This period was selected because it was the period immediately before the law was enacted. For most companies, it was probably a representative period. For others, however, it might have been unrepresentative -- either too high or too low.

In HP's case, the fixed base percentage was clearly higher than average because of two major factors. First, HP's revenue growth was low due to a general downturn for computer companies in 1985, and delays in bringing new products to market. Second, major investments were made in a new computer architecture and technology called RISC ("reduced instruction set computing").

GENERAL R&D INTENSITY

Factors that affect general R&E intensity include:

Product Mix -- If gross receipts from products with low R&E intensity grow more rapidly than gross receipts from products with high R&E intensity, then average R&E intensity will fall. This could occur even if the actual R&E intensity of all products was rising.

Successful Products -- If products are significant commercial successes, gross receipts will tend to grow more rapidly than R&E. This would occur, for example, if a company gained market share from global competitors. Although the argument could be made that a successful company can afford to do more R&D, it seems counterproductive to deny further tax incentives to companies that have been especially successful in commercializing R&E while reserving most of the benefits for companies that are less successful at commercializing R&E.

Increased R&E Efficiency -- By relying exclusively on a historical base without any adjustment mechanism, a company that significantly improves the efficiency of its R&E activities may lose all incentive benefits of the credit. Again, this scenario seems counter intuitive. Although it would not be worthwhile for a company to become less efficient in order to claim a greater R&E credit, companies should not be denied any R&E credit simply because they significantly increase their efficiency at conducting R&E.

U.S. R&E INTENSITY

There are a number of factors that can impact U.S. R&E intensity relative to foreign R&E intensity. Although for a given company worldwide R&E intensity may remain relatively stable over the short run, U.S. R&E intensity could rise, thereby generating more R&E credit, or it could fall, thereby generating less R&E credit.

Shifting R&E to the United States -- By shifting the location where R&E is conducted from a foreign location to the United States, U.S. policy objectives would be supported and a company's R&E intensity, and therefore R&D credit, would increase.

Shifting Manufacturing to the United States -- Shifting manufacturing to the United States would cause R&E credits to fall. This is because U.S. gross receipts would increase thereby reducing U.S. R&E intensity.

Exports -- Increasing the relative portion of a company's worldwide manufacturing done in the United States would cause U.S. exports to rise in order to supply worldwide demand. This increase in exports would increase gross receipts and therefore lower R&E intensity, which in turn would cause a reduction in R&E credits. As in other situations noted above, it seems counterproductive to rely on an R&E credit that penalizes a company for increasing exports from the U.S. faster than its global sales are increasing.

PROPOSED SOLUTIONS

HP has engaged in many discussions over the years about the need for a permanent commitment by the Federal government to encourage U.S. R&D through the R&E credit and about how to structure an ideal R&E credit. We are not sure such an ideal exists. Nevertheless, we do not believe "the perfect should be the enemy of the good," and so we have supported the existing R&E credit.

At this time, we are not convinced that the existing credit should be revised totally. The many factors described above that impact the existing credit make it difficult to focus on one or two that should be dealt with to the exclusion of others.

We strongly urge that the R & E credit be adjusted so that companies that have experienced changed circumstances since 1989, when the R&E intensity concept replaced the three-year rolling average concept, may qualify again for the credit.

We hope a permanent credit is enacted with an adjustment mechanism in place so that companies dramatically increasing U.S. exports, improving R&E efficiency, or shifting the businesses in which they compete are not precluded from receiving any incentive effects of the R & E credit in the future. Because the credit has been in place since 1981, it could be considered to have achieved "quasi-permanence." During this first major review of the structure of the R&E credit since its current format was introduced in 1989, it would be appropriate to correct obvious shortcomings at this time.

HP would offer the following specific proposal that would operate within the general structure of the existing credit (noting that we are open to other approaches as well):

If a company has not received any credit for one year because the base for that year exceeded qualified R&E, then for the next year the fixed base percentage would be recalculated based on the qualified R&E and gross receipts for the year in which no credit is available and for the four prior years. A company should also be able to elect to have this recalculation of the fixed base percentage be conducted for several years, perhaps five, before a final fixed base percentage is set. This will enable companies that are in the middle of fundamental shifts in their business to continue to receive an incentive benefit from the credit while this shift occurs. This opportunity would be available if R & E expenses increase from the prior year.

With regard to how the Congress deals with the credit at this time there appear to be two broad approaches within a limited level of funding for the credit. Congress could make permanent the existing R & E credit, leaving it to those companies or industries not receiving any incentive from the R & E credit to lobby in some future year for some restructuring of the credit. Alternatively, Congress could restructure the credit now so that it would be available to a broader group of companies and then have all companies benefiting or likely to benefit from the credit work together in the future to further enhance the credit. Both approaches could eventually lead us to the same general destination. The second approach just mentioned seems a more appropriate route toward adopting an effective credit of benefit to the broadest range of taxpayers.

Thank you for the opportunity to appear today to share our thoughts with you.
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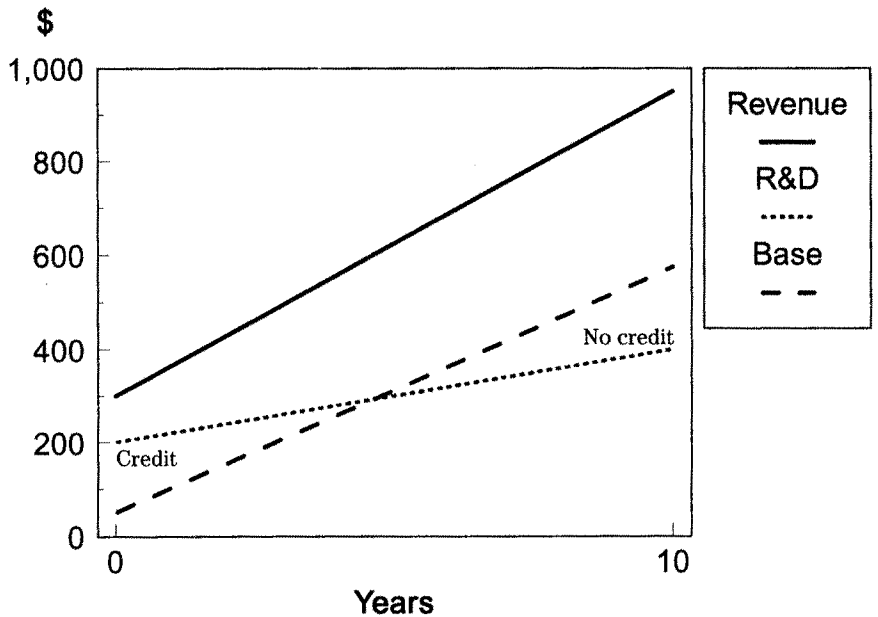
Why Base Restructuring Is Necessary



HEWLETT PACKARD

CORPORATE TAX DEPARTMENT
R&D 1/95

Chairman JOHNSON. Thank you.
Mr. Jernigan.

STATEMENT OF CLIFF JERNIGAN, DIRECTOR, GOVERNMENT AFFAIRS, ADVANCED MICRO DEVICES, INC., SUNNYVALE, CALIF.

Mr. JERNIGAN. Thank you. I am Cliff Jernigan. I am director of Government Affairs at the AMD, Advanced Micro Devices, Inc., one of the largest semiconductor companies. Our major plants are in Sunnyvale, Calif., and Austin, Tex. We have 6,000 people in the United States and 12,000 worldwide. In 1994 our worldwide sales were $2.1 billion. I am here to talk about the research and experimentation tax credit.

The credit is a very worthwhile incentive, but in a nutshell, we do not believe it is relevant to much of American business. It is too complex and it operates in an inequitable manner to many businesses.

The semiconductor industry is one of the leading research investors in the country. We are viewed by government and the private sector as one of the critical industries. In short, we represent some of the most important crown jewels of the kingdom.

Semiconductors drive all of our advances in the electronics industry and in the Information Age. We are exactly the type of company and industry meant to benefit from a research credit. Unfortunately, AMD has not received the credit since the credit structure changed in 1989. We have increased our research spending in absolute dollars every year since 1989. In our research spending, percentage to sales is among the highest in the country at an average of 18 percent for the last 11 years, the time period beginning with the 1984–88 time when you look at R&D to sales for the base point.

The present research credit formula is ill-conceived, favors some industries and taxpayers at the expense of others, and does not fully accomplish its intended effect of increasing U.S. research efforts. Major restructuring of the credit is absolutely essential.

If the present system is to be kept intact, at a minimum, the 5-year base period from 1984–88, which is used to determine the research spending and sales percentage, needs to be moved to a more current time period such as 1990–94. For AMD, we prefer to return to the prior law, the 3-year base period rule, or even go to a new method such as a flat rate credit on current research spending.

We really prefer a flat credit. A flat rate credit has the benefit of being relevant to today's taxpayer—it is simple to administer, and it treats all taxpayers in an equitable manner. It takes the nuances out of the current formula which hurts taxpayers with abnormally high research spending percentages during the 1984–88 base period, or who are experiencing abnormally high sales growth over the past 4 years precisely because of the research investments made earlier, which are coming to fruition in the form of strong sales demand for their products.

In summary, we need to revise the credit to make it relevant, simple, and equitable. AMD favors the flat rate credit.

Thank you very much.

[The prepared statement and attachment follow:]

TESTIMONY OF CLIFF JERNIGAN
OF ADVANCED MICRO DEVICES, INC.
ON THE R&E TAX CREDIT
BEFORE THE WAYS AND MEANS COMMITTEE
ON WEDNESDAY, MAY 10, 1995

INTRODUCTION

My name is Cliff Jernigan. I am Director of Government Affairs at Advanced Micro Devices, Inc. (AMD), one of the largest semiconductor companies in the United States. AMD has major plants in Sunnyvale, California and Austin Texas and employs 12,000 people worldwide.

AMD supports making the Research and Experimentation (R&E) Tax Credit permanent, but only if the Committee fundamentally reforms the structure of the credit. If the credit is to provide the greatest return within current budget or cost limits, the manner in which it is computed must be relevant, equitable and simple, while providing an incentive for taxpayers to invest in research in the United States. We believe the current calculation of the base amount needs significant improvement if the flexibility necessary to meet changing economic and market conditions is to be worked into the credit for the future.

RELEVANT

Current law uses a complicated fixed base percentage formula that was enacted as part of the Omnibus Budget Reconciliation Act of 1989. This formula uses the time period from 1984 to 1988 inclusive to determine the ratio of qualified research expenditures to gross receipts. The 1984 to 1988 time period has lost its significance as a yardstick to determine today's research intensity. In addition, companies that do not have three years of operating history during this 1984 to 1988 time period are classified as "start-up" companies, and their base period is computed under completely separate, more favorable rules. As time passes, a growing percentage of all R&E credit taxpayers will be considered "Start-up" companies. Some of these enterprises are now large publicly held corporations and are still benefiting from the more favorable rules. By not updating this time period to cover a more contemporary interval, the formula will continue to deny credit benefits to taxpayers with increasing research expenditures while unjustly rewarding other taxpayers whose facts and circumstances may not warrant the amount of benefit--resulting in an imbalance that undermines the intent of the program altogether.

EQUITABLE

A tax incentive should treat taxpayers the same when they engage in similar behavior. AMD has continuously increased its U.S. financial statement research and development spending from $203.7 million dollars in 1990 to $280 million dollars in 1994--a 37% increase. From 1984 to 1994, AMD's R&D as a percentage of sales was 18%--one of the highest percentages in the U.S. (see chart attached). Yet AMD has not qualified for the research credit since the (OBRA '89) change to the base year period.

One of the research credit's goals is to provide an incentive to taxpayers to increase their research spending. Clearly, AMD has accomplished this, yet we receive no benefit. Furthermore, AMD would have received a research credit during this period under the old base period rules, or, if AMD qualified as a "start-up" company under the existing rules. This result is inequitable and the effect on AMD and other similarly situated research intensive companies points out the fact that the current base year formula needs to be revised.

SIMPLE

Simpler tax laws are more easily understood by taxpayers. Ease of understanding yields many benefits, including greater compliance with the tax laws at a much lower cost both to the government and the taxpayer.

A more simple and straight forward research credit would also significantly reduce the incidence of unintended adverse consequences, such as AMD is currently experiencing, where research spending is increasing significantly yet no credit is available.

The current base period amount requires a computation of a research intensity ratio over a five-year period beginning in the mid-eighties. Then this ratio must be modified by changes in the definition of qualified research between these years and the qualified expenditures for the current year (i.e., rental expenses). This ratio is then multiplied by the average annual gross receipts of the 4 preceding taxable years. The current rule is anything but simple and may be unreasonable.

An example of the credit computation is as follows:

1. Determine U.S. R&E spending for the years 1984, 1985, 1986, 1987 and 1988
2. Determine U.S. sales for the years 1984, 1985, 1986, 1987 and 1988
3. Divide U.S. R&E spending for the years 1984-88 by U.S. sales for the years 1984-88 to determine the R&E percentage
4. Multiply the R&E percentage times the average sales for the prior four years to arrive at the R&E base
5. Subtract the R&E base from current year U.S. R&E
6. Multiply the difference by 20% to determine the R&E credit

Putting numbers into the above formula, if the R&E percentage in step 3 above is 10% and if the average sales in step 4 above for the prior four years is $1,000,000, then the base will be $100,000 (10% x 1,000,000). If the current year R&E in step 5 above is $150,000, then the difference of $50,000 would be multiplied by 20%, as in step 6 above, to arrive at a credit of $10,000

In our view, a more simple approach would be to include fewer years and more current year information into the determination of the base amount if the incremental structure is preserved. In terms of simplicity, a flat credit based on the current years' qualified costs represents a better and more simple option and would be an appropriate starting point in a modified structure.

AMD'S SITUATION

AMD and the semiconductor industry in general were adversely impacted by Japanese dumping of semiconductor memory products into the U.S. and world markets in the mid-1980's. The dumping coincided with a recessionary period in the U.S. industry. Together, these factors resulted in significant declines in revenue for many semiconductor companies. AMD's financial statement revenue fell from $1.12 billion in 1984 to $795 million in 1985--a 29% decline. AMD's strategy out of this situation was to significantly increase research spending in order to offer superior integrated circuits. Book R&E spending increased from $137 million in 1984 to $173 million 1985--an increase of 26% at the same time that revenues declined by 29%!! This had a disastrous impact on AMD's fixed base period R&E percentage by "artificially" inflating it, making it abnormally high and fiscally impossible to overcome. Clearly the contraction in revenues was out of AMD's control. Fortunately, in this innovate or die situation, AMD did recover and revenues again exceeded $1 billion by 1988 with $1.13 billion in sales.

INCENTIVE FOR U.S. RESEARCH / ALTERNATIVES TO EXISTING CREDIT

The R&E credit operates as an incremental concept--the incentive credits expenditures over a certain threshold--in order to provide the highest possible benefit at the lowest possible cost to the federal Treasury. Currently, the research credit rate is 20%. The consensus of most recent research credit studies is that the credit has been effective in stimulating U.S. research spending. Most of these studies also point out, however, that the temporary nature of the credit does not improve the credit's ability to stimulate additional spending. Furthermore, many foreign countries have recognized the merits of encouraging research activities and have enacted research tax credit mechanisms as well. AMD has complete and reliable knowledge only of its own facts. However, there must be other enterprises with significant research expenditures which find that they too do not qualify for the credit even with R&E expenditures increasing year to year. This fact flies in the face of congressional intent, and unless the basic structure of the credit is corrected, some industries, perhaps numerous in number, would just as soon let the credit lapse.

We believe that no single fixed base period formula can produce a fair credit as a result of the changes that occur within all industries over time. Should Congress choose to retain some form of a fixed base period formula, an alternative should be provided to assure a credit for those taxpayers who are currently increasing research spending. One option would allow taxpayers who have increased research spending in three of the last five years to make an irrevocable election to take a 5% credit on current year qualified research expenditures for the next five years. We support an option to allow a flat rate credit since it is the simplest and most equitable method of computing the research credit. We are not in favor of a "fresh start" that does not recognize that some taxpayers have been prevented from claiming the credit since the change to the fixed base period concept.

Should Congress maintain an incremental credit formula, and if it is willing to reform the fixed base concept, we believe some form of moving base period yields the most equitable result. The moving base period will self correct over time for those industries and taxpayers whose businesses are affected by factors outside that have events beyond their control during the base period that prevent them from qualifying for the credit, even as their research spending increases.

As stated before, a flat rate credit for all qualifying research expenditures is a simple and equitable approach and still provides an incentive to increase meaningful research. Should this option be considered too expensive or as not providing sufficient marginal incentives, tests could be drafted to allow a credit only to those taxpayers whose research efforts--and expenditures--surpass certain limits.

CONCLUSION

We look forward to a restructured and more equitable permanent research credit. We believe that the research credit does stimulate additional U.S. research which results in more high-skill, high-paying jobs, export growth and a higher standard of living for residents. Furthermore, we believe a credit that arbitrarily denies the benefit to taxpayers who increase their U.S. research, is a strong disincentive to continue the conduct of their research activities in the U.S. We hope this paper and the options presented herein help the Committee as it considers the extension and revision of a revitalized R&E tax credit..

AMD RESEARCH AND DEVELOPMENT EXPENSE AS A PERCENTAGE OF SALES
FROM AMD ANNUAL REPORTS
(IN MILLIONS)

	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	TOTAL
SALES	1122	795	829	997	1126	1105	1059	1227	1514	1648	2134	13556
R&D	169	207	223	248	208	202	204	214	228	263	280	2446
	15	26	26.9	24.9	18.5	18.3	19.2	17.4	15	15.9	13	* 18%

(* 11 year average)

SALES 1984 - 1988	4869	SALES 1989-1994	8687
R&D 1984-1988	1055	R&D 1989-1994	1391
R&D %	21.7%	R&D %	16%

Chairman JOHNSON. Thank you very much.
Mr. Jones.

STATEMENT OF ROGER S. SIBONI, NATIONAL MANAGING PARTNER, KPMG PEAT MARWICK, AS PRESENTED BY KENDALL C. JONES, PARTNER, NATIONAL TAX PRACTICE, KPMG PEAT MARWICK

Mr. JONES. Thank you. My name is Ken Jones. I am a partner in the Washington national tax practice of KPMG Peat Marwick. I am here to testify on behalf of Roger Siboni, our managing partner in the Information, Communications and Entertainment line of business, who, I learned about 15 minutes ago, is unavoidably detained and could not be here on time.

We would like to take this opportunity to urge your support of H.R. 803, which would make the R&E credit a permanent provision in the Internal Revenue Code. Moreover, we encourage the adoption of a flexible credit, which would more effectively simulate investment in R&E.

Perhaps the most important point to be made regarding the credit is that it must become a permanent part of the code. While there are two bills pending now that would make the credit permanent, permanence is not yet a reality. We are concerned that in the heat of the legislative negotiations, the R&E credit may be extended once again on a temporary basis.

I would point out that since 1986 the R&E credit has been renewed on a temporary basis six times and structurally modified four times. The uncertainty as to the duration of the R&E credit, coupled with the frequent modifications to the statutory provisions affecting the credit, has resulted in the inability of businesses to effectively plan their research activities. Specifically, a business that plans to conduct research projects is in the position of having to speculate as to whether a temporary credit provision set to expire will be extended.

The typical company is much less likely to commit resources to long-term research activities under those kinds of conditions, because research activities inherently involve risk. Businesses that conduct research need certainty as the tax consequences of their activities. Enacting a permanent credit would provide the certainty that is necessary to budget research activities.

Enacting a permanent provision would also reduce the number of legislative changes to the R&E credit provision because every time the R&E credit must be extended, the opportunity exists for Congress to change the structure of that credit.

The numerous modifications over the years have made it very difficult for the IRS and the Treasury Department to publish meaningful guidance on the mechanical application of the credit. To illustrate that point, the final regulations defining the R&E expenditures were issued in 1994, 13 years after the statute was originally enacted. In the interim, businesses, tax practitioners, and the IRS have relied on regulations that were issued in 1957, 24 years before the credit was even conceived of and enacted.

My specialty at KPMG Peat Marwick is representing clients before the IRS in tax controversies. On behalf of any number of clients, I have been involved in contentious audits involving the R&E

credit issue. These audit issues arise because of the lack of regulatory or procedural guidance from the IRS that has forced taxpayers on their own to address a number of complex, unresolved issues with respect to the computation of the credit. Inevitably, these controversies will continue until we can get that guidance.

The other important issue that must be addressed is structure. Our clients have faced a number of different problems arising from the structure of the credit, arising mostly from base period computations. In fact, many who conduct qualified research can't even claim the credit, due to structural problems with the manner in which the base period is computed.

Therefore, our recommendation to the subcommittee would be to provide as much flexibility as possible with respect to base period computations. Flexibility would improve the usefulness and effectiveness of the credit.

We also want to emphasize that the base period concept is indeed a good concept because it encourages increases in spending. At the same time, we would encourage the subcommittee to adopt some flexibility, such as the flat credit proposal just mentioned, that would allow companies to take full advantage and encourage research in the most meaningful manner possible.

In conclusion, the two points that need to be addressed, in our view, are permanence and flexibility.

Thank you.

[The prepared statement follows:]

KPMG Peat Marwick LLP

STATEMENT OF ROGER S. SIBONI
National Managing Partner
Information, Communications & Entertainment Practice of
KPMG PEAT MARWICK LLP

AS PRESENTED BY KENDALL C. JONES
PARTNER, KPMG PEAT MARWICK, NATIONAL TAX SERVICE

May 10,1995

As the National Managing Partner of the Information, Communications & Entertainment line of business of the international accounting and consulting firm of KPMG Peat Marwick LLP, I would like to take this opportunity to urge your support of H.R. 803 which would make the Research & Experimentation Credit a permanent provision in the Internal Revenue Code. Moreover, I encourage the adoption of a flexible credit provision which would more effectively stimulate investment in R&E.

Need for a Permanent Credit

The call for permanent enactment of the Research & Experimentation Credit is coming from all corners. The House of Representatives has twice passed a permanent extension (in 1989 and 1993) and again seeks to do so with H.R. 803, sponsored by Chairman Johnson, originally co-sponsored by Congressmen Matsui, Herger and Neal, and since co-sponsored by fifty additional Representatives. The Senate has acted through Senators Domenici and Danforth, who both proposed permanent extensions in 1994, and Senator Hatch, who called for permanent extension this year with S. 351. Recently, President Clinton has called for a permanent extension "to stimulate private investment." Nonetheless, permanence is not yet a reality, and I am concerned that in the heat of the legislative negotiations process, the R&E Credit may be extended temporarily rather than permanently.

Since 1986, the R&E Credit has been temporarily renewed six times and structurally modified four times. The uncertainty as to the duration of the R&E Credit coupled with the frequent modifications to the statutory provisions affecting the credit has resulted in the inability of businesses to plan their research activities. Specifically, a business that plans to conduct a long-term research project must speculate as to whether a temporary credit provision set to expire during its research project will, in fact, be extended. Even though the temporary R&E Credit has always been extended by Congress, sometimes retroactively, business forecasting and tax planning cannot be performed retroactively. The typical company is less likely to commit resources to long-term research activities if it is unable to reasonably estimate the after-tax costs of such projects. Thus, the repeated enactment of a temporary R&E Credit reduces the incentive to plan extensive R&E activities. Because research activities inherently involve risks, businesses that conduct research need certainty as to the tax consequences of their activities. Enacting a permanent R&E Credit would provide the certainty that is necessary to reasonably budget research activities.

Enacting a permanent provision also would reduce the frequency of legislative changes to the R&E Credit provision because every time a temporary R&E Credit must be extended, an opportunity exists for modifying the structure of the credit. The numerous modifications have made it difficult for the Internal Revenue Service to publish guidance on the mechanical application of the R&E Credit. To illustrate, the final regulations defining "research and experimental expenditures" were issued in 1994, thirteen years after the statute was originally enacted. In the interim, businesses,

tax practitioners and the Internal Revenue Service have relied on regulations originally issued in 1957, twenty-four years before the R&E Credit was first enacted.

By way of another example, a 1986 amendment to the R&E Credit excluded the development of software for internal use except as provided by the regulations. The Conference Agreement indicated that the development of internal use software should qualify if it is innovative, commercially unavailable, and involves significant economic risk in its development. Nine years later, there is still no regulatory guidance from the IRS, demonstrating how the repeated expiration dates and statutory changes have resulted in the inability of the government to keep up with the statute.

The lack of regulatory guidance has forced taxpayers to address a number of complex, unresolved issues when computing the R&E Credit. Inevitably, many of the positions taken by taxpayers in the absence of regulatory guidance will be challenged by the IRS, thus increasing the economic costs of taking the R&E Credit.

The statute has been extended six times, never more than three years and sometimes retroactively:

- The Economic Recovery and Tax Act of 1981 enacted the "Credit for Increasing Researching Activities" with a five year duration.
- The R&E Credit expired December 31, 1985.
- The Tax Reform Act of 1986 retroactively renewed the R&E Credit and extended it three years.
- The Technical & Miscellaneous Revenue Act of 1988 extended the R&E Credit one year.
- The Omnibus Budget Reconciliation Act of 1989 extended the R&E Credit one year.
- The Omnibus Budget Reconciliation Act of 1990 extended the R&E Credit one year.
- The Tax Extension Act of 1991 extended the R&E Credit through June 30, 1992.
- The R&E Credit expired June 30, 1992.
- The Omnibus Budget Reconciliation Act of 1993 retroactively renewed the R&E Credit, extending it to June 30, 1995.

In addition to the uncertainty regarding the duration of the provision, there remains continual doubt as to the structure of the R&E Credit, because along with these prospective and retroactive extensions have come four direct modifications to the R&E Credit supplemented by amendments to related provisions. For example:

- In 1986, "qualified expenditures" were more narrowly defined and the R&E Credit was reduced from 25% to 20% and made subject to the General Business Credit cap.
- The 1988 extension carried with it a reduction of R&E deductions by 50% of the R&E Credit for that year.
- OBRA 1989 changed the method of calculation of the R&E Credit and further reduced the allowable §174 deduction.
- OBRA 1990 repealed the special proration provision of OBRA 1989, but due to an as yet uncorrected technical error, taxpayers with a fiscal year ending in the fourth quarter of 1989 lost up to three months worth of credit.
- OBRA 1993, which extended the R&E Credit through June, 1995 modified the fixed base percentage for start up companies.

The R&E Credit was initially enacted in 1981 with a five year duration so that Congress could evaluate the operation of the credit. After thirteen years of observation and alteration, the concept of the R&E Credit remains as intended, a valuable incentive to encourage investment in the technological future of our country.

Who is Affected?

When discussing the subject of research and experimentation, thought may first turn to Silicon Valley, the home of many small high-technology start-up companies that have been responsible for numerous technological innovations in recent years. Yet it may surprise some that one of the largest high-technology commercial areas lies within Utah. While discussing research and experimentation, one may think of large Texas, California or Michigan defense contractors whose efforts have contributed to a strong, high-technology military. But technology-based industry is present throughout the entire country, affecting businesses and people in every state. The R&E Credit affects not only the large high-technology firms that often come to mind, but also offers great relief to small firms in the biochemical, pharmaceutical, agricultural, manufacturing, and service industries, as well as start-up businesses desperately in need of cash flow.

Do We Need a Research & Experimentation Credit?

The United States is not a global leader when non-defense research and experimentation is measured as a percentage of Gross Domestic Product; for instance, Japan and Germany both have a higher rate of non-defense research activities as a percentage of Gross Domestic Product. While other nations provide greater tax incentives to research, and in some instances government sponsorship of such research, the Internal Revenue Code, in certain cases, fails to promote R&E activities to the same degree as other countries. For example, small, high-technology start-up firms are often in need of capital at certain key points during R&E projects. In today's economic environment, such capital is often acquired by selling the business to a larger, cash-rich entity. However, with the fifteen year amortization period for intangibles provided by I.R.C. §197, domestic capital is often squeezed out of the market by foreign investors, many of whom are afforded by their governments shorter periods in which to write-off intangibles. The R&E Credit has helped to ease the cash flow issues faced by these capital-starved entrepreneurs.

Most economists agree that government support in the form of the R&E Credit is justified and desirable. From a macro-economic perspective, technology breeds productivity which in turn results in higher wages and a better standard of living. In fact, a recent study done by the Policy and Economics Group of KPMG Peat Marwick LLP, entitled "Extending the R&E Tax Credit: The Importance of Permanence," indicates that for every one dollar of R&E Credit, research expenditures increase by one dollar in the short run and by two dollars in the long run. This suggests that the credit has a beneficial impact on the gross domestic product. However, while investment in technology produces a long-term societal benefit, it does not necessarily produce an immediate return on investment to a company conducting the research due to the inherent risk in most innovative research activities.

The R&E Credit's societal benefit is derived from the fact that research conducted by any given company often has a spill-over effect on competitors and businesses in other industries. For example, the development of a new piece of machinery will result in the development of similar machinery designed to compete with the original. This competition benefits the consumer and society as a whole, but at the same time, it limits the profitability to the original inventor. Consequently, since businesses see limited returns on investments in developing new technology, there is a reduced incentive for funding research. The R&E Credit mitigates this natural economic disincentive to incur R&E expenditures.

The Impact on an Uncertain Economy

The impact of the R&E Credit on a thriving economy is obvious. During the boom of the early eighties when the R&E Credit was first enacted, research activity grew at a rate in excess of double the growth rate of the Gross Domestic Product. However, R&E is one of the first expenses to be cut during uncertain economic times, since the benefits of such expenditures are, by their very nature, long term. When a need to reduce short term expenses arises, expenditures which cannot demonstrate an immediate return are cut. The R&E Credit combats this phenomenon.

To illustrate, according to published reports, a large, high-technology firm recently released its first quarter earnings. Although investment in research for this firm had essentially remained constant, sales had dropped 20 percent. The result was an increased rate of investment in research and experimentation over the previous base which in turn will result in a larger credit. The R&E Credit will have the effect of easing an economically difficult period which may have otherwise resulted in a management decision to reduce the level of research.

Structure of the R&E Credit

The Subcommittee has also indicated a desire to examine the structure of the R&E Credit. Presently, the R&E Credit is based upon the increase in the rate of R&E expenditures over a base period. While this provides an incentive to increase R&E expenditures beyond the base, there is a debatable assumption that the base accurately reflects an appropriate minimum standard of expenditures on research. At both a macro-economic and a micro-economic level, change in the business community is continuous. Due to overall economic changes, R&E expenditures have dropped since the mid-1980's. Since the fixed base period can be static, it is not necessarily a relevant barometer for determining the value of an R&E Credit in a changing economy. As a result of the current structure, many entities that conduct valuable research cannot avail themselves of the R&E Credit due to the unique factors which may affect any single business.

Because the business environment is constantly changing in both macro-economic and micro-economic terms, I urge Congress to make the R&E Credit as flexible as possible. The existing increase-over-base concept should be retained. However, many companies have been unable to utilize the R&E Credit under the current structure due to the circumstances previously described. A remedy for the static base issue would be to allow businesses to elect from a menu of base period options. The base period election could provide alternatives to the taxpayer which would include a three or five year rolling average base period, akin to the base period as reflected in the statute as originally enacted in 1981. Another option would be to allow a business to reset the fixed base period to the most recent five years. Perhaps Congress could limit these elections to entities that have failed to qualify for the R&E Credit for two consecutive years. These types of options would allow enough flexibility with the R&E Credit to avoid the economic issues described above.

One additional alternative Congress should consider is an elective Minimum Flat Credit. Such a credit would be calculated using a flat-rate percentage applied to qualified R&E expenditures. A Minimum Flat Credit would always provide an incentive for R&E investment, regardless of the change in the company's circumstances. In other words, a Minimum Flat Credit would eliminate any anomalies created by the base period method.

CONCLUSION

The Research and Experimentation Credit should be granted permanent status within the Internal Revenue Code. The repeated short term implementation and frequent modifications breed uncertainty, which undermines the effectiveness of the R&E Credit. Furthermore, the R&E Credit should be modified to provide for a more flexible base period and a Minimum Flat Credit, so as to provide a continued incentive for investment in research and experimentation regardless of the change of circumstances which may effect a business.

Chairman JOHNSON. Thank you.
Mr. Gutman, welcome back.

STATEMENT OF HARRY L. GUTMAN, COUNSEL, KING & SPALDING, ON BEHALF OF GENERIC PHARMACEUTICAL INDUSTRY ASSOCIATION, NATIONAL ASSOCIATION OF PHARMACEUTICAL MANUFACTURERS, AND NATIONAL PHARMACEUTICAL ALLIANCE

Mr. GUTMAN. Thank you very much Madam Chair, members of the subcommittee. I am Hank Gutman, a partner in the law firm of King & Spalding, and I am appearing today on behalf of the Generic Pharmaceutical Industry Association, the National Association of Pharmaceutical Manufacturers, and the National Pharmaceutical Alliance.

The organizations that I represent support the permanent extension of the credit and urge that in connection therewith, the Congress take this opportunity to reiterate what has been its previously expressed intent that expenses incurred in the process of developing generic drugs have been and will continue to be eligible for the credit.

In a sense, it is fortuitous that this hearing is being held before the Oversight Subcommittee, because the issue that I am addressing is in part an oversight matter.

As claimed on their tax returns by manufacturers of generic drugs, the R&E credit plays an important role in maintaining an economically viable generic drug industry, and the maintenance of an economically viable generic drug industry is an important component in the quest to contain health care costs. Unfortunately, the IRS has taken the position that the developers of generic drugs are, per se, ineligible to claim the credit for their premarketing development costs and costs to secure FDA approval of their products as new drugs. Moreover, the Treasury Department, despite having testified in October 1994 before the Select Revenue Measures Subcommittee of this committee that generic manufacturers should be subject to a facts-and-circumstances determination to determine eligibility for the credit, has refused to exercise its policy prerogative in intervening with the IRS regarding the IRS' interpretation of the scope of the credit. As a result, a stalemate has been created by the Treasury's failure to follow through on its testimony, and the organizations now have to come to the Congress to ask for clarification of congressional intent that the credit is available for these expenses. This is the only alternative that these entities have other than costly litigation.

My statement describes in detail the process of developing and securing regulatory approval for a generic drug, and it also demonstrates how that process results in expenses that are eligible for the credit. In the balance of my time, I would like to flesh out why it is that we are here.

The IRS has taken the position that the developers of generic drugs are, per se, ineligible to claim the credit. The IRS position is based on a code provision that excludes from the credit expenses that are related to the reproduction of an existing business component from a physical examination of the business component or from plans, blueprints, details, specifications, or publicly available

information. The Service says that this exception applies to the expenses that are incurred in producing a generic drug.

That position of the IRS is unwarranted under the statute; it is factually inaccurate, and it is contrary to congressional intent. No. 1, a generic drug is not developed from a physical examination of a target drug or from publicly available information. Therefore, the process of development of a generic drug is not described by the statute.

No. 2, generic drugs may improve on the target listed drug in terms of shelf life and stability, to say nothing of lowering costs.

No. 3, the legislative history of the duplication exception makes it clear that the reproduction that is meant there is reverse engineering of an existing product, not the development of an alternative by original research and experimentation. The process of developing a generic drug does not in any sense constitute reverse engineering.

Finally, the FDA views generic drugs as new drug products.

Over the past number of years, members of the industry have attempted to persuade the IRS to reverse its position. In Treasury testimony, the Treasury basically adopted the industry position, but has not indicated any willingness to try to get the IRS to change its position. Consequently, members of the industry are in the frustrating position of being betwixt and between the Treasury and IRS and, consequently, have come before the subcommittee to ask that as this legislation goes forward that their concern be resolved.

I thank you.

[The prepared statement follows:]

STATEMENT OF

HARRY L. GUTMAN

On behalf of the Generic Pharmaceutical Industry Association, the National Association of Pharmaceutical Manufacturers, and the National Pharmaceutical Alliance

HEARING BEFORE THE

Subcommittee on Oversight
Committee on Ways and Means
U.S. House of Representatives
on the
Research and Experimentation Tax Credit

May 10, 1995

Madam Chairman and Members of the Subcommittee:

My name is Hank Gutman. I am a partner in the law firm of King & Spalding. I am pleased to appear before the Subcommittee today on behalf of the Generic Pharmaceutical Industry Association, the National Association of Pharmaceutical Manufacturers, and the National Pharmaceutical Alliance (the "Organizations"). The Organizations support the permanent extension of the research and experimentation tax credit (the "R&E credit") and urge that in connection therewith the Congress reiterate its previously expressed intent that the expenses incurred in the process of developing generic drugs have been, and will continue to be, eligible for the R&E credit.

This reiteration of Congressional intent is necessary because, as described in more detail below, the Internal Revenue Service ("IRS") has taken the position in a number of audits of generic drug companies, and in a technical advice memorandum, that developers of generic drugs are per se ineligible to claim the R&E credit for their premarketing development costs and costs to secure Food and Drug Administration ("FDA") marketing approval of their products as new drugs. Moreover, the Treasury Department, despite having testified on October 6, 1994 before the House Ways and Means Subcommittee on Select Revenue Measures that generic drug manufacturers should be subject to a "facts and circumstances" determination process to determine eligibility for the R&E credit, has refused to exercise its policy prerogative and intervene with the IRS regarding its interpretation of the scope of the credit. As a result of the stalemate that has been created by the Treasury's deliberate failure to follow through on its Congressional testimony, the Organizations are compelled to seek Congressional clarification as an alternative to costly litigation.

The balance of this statement first describes the issue in more detail. It then describes the process of developing and securing regulatory approval for a generic drug. Third, the statement discusses current law governing the allowance of the R&E credit, as well as the Congressional intent in enacting that legislation, and demonstrates that the process of creating a generic drug falls squarely within the ambit of expenses that

Congress intended to qualify for the R&E credit. Finally, the statement describes the alternatives now available to the Congress.

THE ISSUE

The IRS has taken the position that developers of generic drugs are per se ineligible to claim the R&E credit for their premarketing development costs and costs to secure Food and Drug Administration marketing approval of their products as new drugs. Internal Revenue Code Section 41(d)(4)(C)[1], which excludes from the credit expenses related to the reproduction of an existing business component from a physical examination of the business component itself or from plans, blueprints, details, specifications, or publicly available information, applies to these expenses. In rationalizing this conclusion, the TAM states,

> We believe the statutes and legislative histories ... are evidence that a generic drug is a duplication of another taxpayer's business component and the development of the generic drug is excluded from the definition of the term "qualified research" under Section 41(d)(4)(C) of the Code. TAM, p.9.

The TAM also states,

> It is our view that Congress considers generic drugs for approval under the ANDA procedure to be duplications of existing listed drugs. Drugs approved under the ANDA cannot improve on the target listed drug. TAM, p.10.

The conclusion stated in the TAM is unwarranted under the statute, factually incorrect and contrary to Congressional intent. First, as discussed more fully below, a generic drug is not developed from a physical examination of a target drug or from publicly available information. Thus, the process of development of a generic drug is not described by the literal language of the exclusion. Second, generic drugs may improve on the target listed drug in terms of shelf life and stability, to say nothing of cost. Third, the legislative history of Section 41(d)(4)(C) makes clear that "reproduction" means reverse engineering of an existing product, not development of an alternative by original research and experimentation. Again, as described in more detail below, the process of developing a generic drug product does not in any sense constitute "reverse engineering." Furthermore, FDA views generic drugs as new drug products.

In a number of meetings, the taxpayer to whom the TAM was directed attempted to persuade the IRS that the IRS position was incorrect. When it appeared the IRS would not change its position, that taxpayer, together with the Organizations, brought the issue to the attention of several members of Congress. Their effort culminated in a legislative proposal during the last Congress to clarify the application of the R&E credit to expenses incurred in developing generic drugs. Under the proposal, a generic drug would not be treated per se as a duplication of an existing business component. That is, Section 41(d)(4)(C) would specifically state that mere "duplication" of performance by an

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[1] Section references are to the Internal Revenue Code unless otherwise noted.

alternative product would not preclude the credit, so long as all the other conditions of Section 41 were satisfied. Therefore, taxpayers would be permitted to show, on a facts and circumstances basis, that the expenses incurred in conducting "research and experimentation" to produce a generic drug would qualify under Section 41.

The proposal was the subject of a hearing on October 6, 1994 before the Select Revenue Measures Subcommittee of this Committee. At that hearing, Glen Kohl, the Tax Legislative Counsel, took the position on behalf of the Treasury that

> the costs of developing a product that is new for a particular taxpayer can qualify for the credit even though other taxpayers already offer similar products. The only express limitation that applies to competing products is the exclusion for products developed by duplication . . . . The question of whether the development of generic drugs is qualified research or nonqualified duplication should be resolved on a case-by-case basis, using the same standards that apply to other products in taking into account all of the relevant facts and circumstances of each case. Hearing Record, p.9.

Congressman Payne asked Mr. Kohl "[I]s it the position of the Treasury that a generic drug is simply a duplication of a brand name drug?" Mr. Kohl responded, "[w]e think that for a generic drug you have to look at the facts and circumstances . . . . The Treasury Department is . . . saying . . . that the rules the Congress has enacted in the past should apply to the facts involved in developing a generic drug." Hearing Record, p.13. Later, Mr. Kohl noted that if the duplication issue were resolved favorably the credit would be available for the expenses of developing the generic drug. Id.

Treasury's description of the scope of the R&E credit is precisely what the industry has previously argued to the IRS. That position is completely consistent with the legislative history of the R&E credit.

Subsequent to the hearing, representatives of the taxpayer and the Organizations met with Mr. Kohl and Paul Kugler, Assistant Chief Counsel of the IRS in charge of Passthrough and Special Industries, in an attempt to resolve the inconsistency between the Treasury's statements and the holding of the TAM. In that meeting the scope of the duplication exclusion was discussed further. The question posed was whether, assuming all other conditions of the R&E credit were satisfied, the mere fact that a taxpayer's product achieved similar or the same performance or results as another's would by itself preclude the R&E credit under the duplication exception. (For example, would a synthetic diamond developed by qualifying research and experimentation be disqualified from the R&E credit?) Mr. Kohl stated that in his view it would not. In contrast, Mr. Kugler appeared to be of the view, with respect to generic drugs having an active ingredient which is composed of the same molecule as the brand product, that "bioequivalence" of drug performance as required by FDA law is fatal to the R&E credit under the duplication exception. Treasury and the IRS were asked to reconcile their apparent conflict, perhaps in the context of a revenue ruling project. Mr. Kohl indicated that the appropriate course of action was to pursue the matter further with the IRS.

On March 7, 1995, following Mr. Kohl's suggestion, representatives of the taxpayer and the Organizations met with Marlene Gross, Acting Deputy Chief Counsel of the IRS, Mr. Kugler and members of their staffs to discuss the matter further. At that meeting it was made clear that in the IRS view any generic drug product that (i) uses the same molecule of active ingredient as the corresponding brand product, and (ii) achieves the same therapeutic result as a brand name product is excluded from credit benefits by Section 41(d)(4)(C). It was also clear that Ms. Gross, who is in a position to overturn that IRS position, has no intention of so doing.

Virtually all of the generic industry products meet these two conditions. Moreover, despite contrary Treasury views, the IRS has made it clear that it will not change its position. It is thus highly likely that this position will be taken by IRS auditing agents against all companies manufacturing generic products to preclude the tax credit for such products. Therefore, the only avenues to resolution of this issue are litigation on the individual companies' tax deficiencies or legislation. Litigation is expensive and an unnecessary and unfair use of both taxpayer and Government resources in light of the statute, Congressional intent and Treasury's expressed views. Congressional reiteration of its original intent would eliminate the problem.

DEVELOPING AND SECURING REGULATORY APPROVAL FOR A GENERIC DRUG

A generic drug product is a new drug that can achieve the same therapeutic results as a brand name drug product and that can be substituted in prescriptions for the brand name product. What is new are the formula of inactive ingredients and the manufacturing and delivery process, and the research and experimentation of a generic drug manufacturer focuses on that.

A generic drug is developed by original research that delivers a known active ingredient using a newly developed and unique combination and ratio of inactive ingredients with the active ingredient. While a generic product usually uses the active ingredient having the same molecular structure as the brand product, the other physical characteristics of the generic's active ingredient, such as the polymorphic form, impurities, and particle size, often affect the bioavailability of the final drug. Such effects must be compensated for by variations (i.e., differences) in the inactive formula and/or manufacturing process of the generic product (from those of the brand), so that the generic product is "bioequivalent" to the brand within a tolerance allowed by the FDA. Such compensation (and other factors) usually result in the generic product having a different formula of inactive ingredients and a different manufacturing process from the brand.

The identity, type, nature, characteristics and sources of each inactive ingredient must be intensively researched and evaluated because each ingredient must serve a specific purpose in the final formulation. Variations in combinations and identity of inactive ingredients with the active ingredient affect performance, as measured by bioavailability. The quantity and ratio of the inactive ingredients must be developed in combination with the active ingredient in the generic manufacturer's own formulation to achieve a successful generic drug product. Every aspect of the formulation of any drug

product requires a delicate balance to achieve the desired result. Moreover, in addition to its own formulation, the generic drug manufacturer creates a new manufacturing process. That process described in detail the record of the October 6, 1994 hearing at pages 27 to 30.

A generic drug is, by definition, a new drug under the Food, Drug and Cosmetic Act (the "FDC Act"). 21 U.S.C. § 321(p)(1) (1988). It is a violation of the FDC Act to market a new drug in interstate commerce unless the FDA has approved a new drug application for the drug. 21 U.S.C. §§ 355(a), 331(d).

A generic drug may be approved through one of two types of new drug applications. The only difference between FDA approval standards for the two types of new drug applications, (1) full new drug applications ("NDA") and (2) abbreviated new drug applications ("ANDA"), is that ANDAs require bioequivalence data rather than clinical studies. Compare 21 U.S.C. § 355(b)(1)(A)-(F) with 21 U.S.C. § 355(j)(2)(A)(i)-(vi). Although an ANDA need not contain information on safety and effectiveness investigations, it is required to contain data demonstrating bioequivalence to a "listed" drug, i.e., a drug previously approved in a full NDA. If a generic drug company's initial tests do not demonstrate bioequivalence, the company must alter its formulation and/or manufacturing process and retest. The cycle of testing and revising the formulation is followed until (1) the tests indicate that the two products are bioequivalent within a range of plus or minus 10% to 20% with respect to the rate and extent of absorption or (2) the company fails to achieve its objective abandons its effort.

An ANDA must contain the same types of information concerning components, composition, manufacturing methods, samples, and labeling, as a NDA. 21 U.S.C. § 355(j)(2)(A)(i)-(vi) (1988). Because the FDA considers each new drug as a unique product, an ANDA is not required to compare its qualitative and quantitative formulation and manufacturing process with that of the listed drug's manufacturer. See 21 U.S.C. § 355(j)(3) (1988). Each new drug's performance depends on product-specific variables, including chemistry, manufacturing, and control factors that are specific to the manufacturer and its product.

For each new product it attempts to develop, a generic drug manufacturer goes through a process of experimentation to discover chemical properties of its source of the active ingredient, the dosage form technologies, combinations of inactive ingredients with the active ingredient, enclosures, and the equipment and manufacturing techniques that will produce a product that satisfies the ANDA performance test.

CURRENT LAW AND CONGRESSIONAL INTENT

Section 41(a), originally enacted as Section 44F in 1981, allows a tax credit for incremental "qualified research" expenses. Section 41(d)(4)(C), enacted in 1986, excludes from the definition of qualified research "any research related to the reproduction of an existing business component (in whole or in part) from a physical examination of the business component itself or from plans, blueprints, detailed specifications, or publicly available information with respect to such business component." The Treasury has yet to issue Regulations interpreting Section 41(d)(4)(C).

In many cases the IRS has conceded that, but for Section 41(d)(4)(C), the expenses of developing a generic drug would constitute qualified research expenses. However, it takes the position that Congress intended generic drugs submitted for approval under the ANDA procedure to be "duplicative" of existing drugs and therefore ineligible for the credit under Section 41(4)(C).

A generic drug is not a "duplicate" of an existing drug. The FDA has supplied a statement included is the record of the October 6, 1994 hearing at pages 30 and 31, explaining the FDA's requirements for approving a generic drug and the agency's interpretation of the status of generic drugs under the FDC Act. In the view of the FDA, "Because a generic drug's performance depends on product specific variables, the FDA considers each generic drug as a distinct product. ... A generic drug is, therefore, not the same drug as the one approved in the NDA."

Second, the activities listed in Section 41(d)(1)(4) are Congress' express illustrations of situations in which the credit will not be allowed because the research is not research in the experimental sense. A generic drug company's research activities are clearly experimental.

Thus, the scope of the exclusion of research related to reproduction of an existing business component from an examination is the critical question. Although the heading of Section 41(d)(4)(C) is "Duplication of Existing Business Component," as noted above the exclusion is for "research related to the reproduction of an existing business component (in whole or in part) from a physical examination of the business component itself or from plans, blueprints, detailed specifications, or publicly available information with respect to such business component." Because a generic drug company conducts its own original research to produce its own new business components, and does not copy existing products by cloning or reverse engineering, its research activities are eligible for the Section 41 credit under current law.

The legislative history on this issue specifically states, "The exclusion for duplication does not apply merely because the taxpayer examines a competitor's product in developing a different component through a process of otherwise qualified experimentation requiring the testing of viable alternatives and based on the knowledge gained from such tests." H. Rep. No. 841, 99th Cong., 2nd Sess. (1986), at II-75 (report of the Conference Committee on the Tax Reform Act of 1986, Pub. L. No. 99-514) [hereinafter "1986 Conference Report"]. The plain implication is that a taxpayer who examines a competitor's product that achieves a particular result and then, through experimentation, develops its own original product that duplicates the result achieved by the competitor's product, is entitled to the Section 41 credit. The original formulation and manufacturing process developed in connection with a generic drug are clearly new and different business components under the statute.

As explained in the 1986 Conference Report, duplication means producing something that exactly corresponds in composition and structure to an original. The House Ways and Means Committee Report explanation of the Section 41 changes in P.L. 99-514 (H.R. Rep. No. 426, 99th Cong., 1st Sess. (1985)) defines duplication as "The reproduction of an existing business item of another person from a physical examination of the item itself or from

plans, blueprints, detailed specifications, or publicly available information with respect to such item." Such duplication is referred to as "reverse engineering" in the 1986 Conference Report at II-75, restating the language from the Ways and Means Committee report cited above. A generic drug invention is not a duplicate or a reproduction, but is a new and different product; the new product duplicates results, but the product itself is not a duplicate or a reproduction.

The conclusion that generic drug research should be entitled to the credit is reinforced by the numerous references to drug products in the legislative histories of Section 41 and Section 174. In particular, the legislative history of Section 41 is crystal clear: "[C]osts of experiments undertaken by chemists or physicians in developing and testing a new drug are eligible for the credit because the researchers are engaged in scientific experimentation."

Moreover, it is also clear from various amendments to the FDC Act and from legislative history that Congress intended to encourage the development of generic drug products. For example, in 1984, Congress estimated that the availability of generic equivalents to brand name drug products approved after 1962 would save American consumers $920 million over 12 years. H.R. Rep. No. 857, 98th Cong., 2d Sess., pt. 1, at 17 (1984). Older Americans, in particular, would benefit, since they use almost 25% of all prescription drugs. Id. In addition, the federal government would save millions of dollars from the increased availability of generic drug products, since it purchases drugs through the Medicaid program and in veterans' and military hospitals. Id. at 17, 19. State governments would also save on drugs purchased through Medicaid. Id.

The availability of high quality, low cost alternatives to brand name drug products is desirable from both an economic and a public health standpoint. A generic drug product is usually sold for a significantly lower price than a brand name product. As mentioned above, the lower level of costs of research for generic drug developers compared to the development of a brand name drug results in lower credit compared to the major pharmaceutical houses, but it does not mean that the credit is not a major incentive for research.

The research required to develop a generic drug product consists of experiments related to the physical content, form and production process of the new drug, and, once a model has been developed, studies that compare the model's bioavailability with the bioavailability of the target brand name product. These studies are necessary in order to obtain FDA approval to market the generic drug product. 21 U.S.C. § 355(j)(2)(A)(iv) (1988). This process is less expensive, however, than the process would be if it also included the clinical studies necessary to show that a drug product is both safe and effective for the purpose for which it will be marketed. H.R. Rep. No. 857, 98th Cong., 2d Sess., pt. 1, at 19.

The potential for lower cost prescription drug products was one of the major factors that Congress discussed in connection with 1962 amendments to the Food, Drug, and Cosmetic Act. Drug Amendment of 1962, Pub. L. No. 87-781. The FDA established a procedure for submitting abbreviated new drug applications (ANDAs) for new generic versions of brand name products initially approved before enactment of the 1962 Amendment. See 21 C.F.R.

314.56 (removed by 57 Fed. Reg. 17950, 17963 (April 28, 1992)). In a further effort to expand the use of lower cost generic drug products and increase competition within the pharmaceutical industry, Congress enacted the Drug Price Competition and Patent Term Restoration Act of 1984. Pub. L. No. 98-417. This Act amended the Food, Drug, and Cosmetic Act by adding an ANDA procedure for generic equivalents to any FDA-approved drug product for which a valid patent was not in force. 21 U.S.C. § 355(j).

Congress clearly intended to encourage the development of generic drug products by enacting special FDA procedures. Excluding the costs of such development from eligibility for research-related tax benefits would flatly contradict that intent. Allowing research credits for brand name drug product development while denying such credits for generic drug product development would decrease the competitiveness of generic drug products, discourage the development of generic products, and increase the costs of generic products. Congress certainly did not intend the application of the R&E credit to produce such results.

CONCLUSION

It is frustrating to have to submit a statement to the Subcommittee and suggest that clarifying legislation is necessary because the Treasury will not exercise its tax policy authority and direct the IRS to interpret the statute in accordance both with its views as expressed before a Congressional Committee and with Congressional intent. The generic drug industry believes the result it seeks would ultimately be achieved through costly, time consuming litigation. Clearly these costs can be totally avoided if the IRS were to change its position. If it does not, clarifying legislation will be needed to resolve the issue.

Chairman JOHNSON. Thank you very much.
Mr. Steel.

STATEMENT OF GORDON M. STEEL, VICE PRESIDENT OF FINANCE AND CHIEF FINANCIAL OFFICER, XILINX, INC., SAN JOSE, CALIF.

Mr. STEEL. Thank you. Madam Chair and members of the subcommittee, good afternoon. I am Gordon Steel. I am the vice president of Finance and chief financial officer for Xilinx, Inc. I wish to thank the subcommittee for providing me the opportunity to testify on what I consider to be a technical flaw in the R&D credit definition as it applies to startup companies. This has often been referred to as the R&D equivalent of the "notch baby" issue.

By way of background, Xilinx is based in San Jose, Calif., and is the world's largest supplier of programmable logic semiconductors and related development systems software. Founded in early 1984, Xilinx, in late 1985, introduced a new programmable component, the field programmable gate array, or FPGA. This market is currently in the vicinity of $400 million in size, and is projected by some analysts to grow to some $1.5 billion by the end of this decade.

In the fiscal year that ended March 1995, Xilinx reported revenues slightly in excess of $350 million. We currently have approximately 1,000 employees of whom 750 are located in San Jose, Calif.; roughly 250 are employed in R&D. I note in passing that two companies represented on this panel are customers of ours.

Perhaps the most critical ingredient in fueling Xilinx's growth has been our substantial commitment to research and development in a variety of areas including software development, integrated circuit design, and manufacturing process engineering. The success of our R&D efforts has provided our customers with the industry's broadest range of products and with consistent predictable enhancements in performance and reductions in cost. It has also led to substantial increases in employment not only at Xilinx, where employment has grown more than 25 percent annually, but also for many of the firms with whom we work.

The pace at which new technology is introduced is accelerating rapidly. Accordingly, I am convinced that the commitment to research and development in the future will be even more critical tomorrow than it is today.

The implementation of the R&D tax credit has significantly expanded business commitment to R&D, not only for startup companies like Xilinx, but also for many major corporations as well. I am concerned, however, that a technical glitch concerning the definition of a startup company will severely limit or even eliminate the intended benefits of the R&D credit for those fast-growth corporations who commenced operations in 1984, 1985, or 1986. This includes companies such as Sierra Semiconductor of California, Sequent Computer Systems of Oregon, and Xilinx.

The explanation of this technical glitch is rather complex. Under the current approach, only qualified research expenses over a fixed base amount are eligible for the credit. In 1989 the computation of the fixed base amount was changed. Recognizing that companies in a startup mode will experience distorted relationships between re-

search expenses and gross receipts, Congress provided a special base for startup companies. Specifically, those companies that did not have gross receipts and qualified research expenses during at least 3 years of the base period beginning 1984 through 1988 were eligible to use a lower ratio of qualified research expenses to gross receipts.

This definition inadvertently introduces a problem, since those companies that were unfortunate enough to have started operations in 1984, 1985, or 1986 were ineligible to use the lower ratio. Xilinx's experience can highlight this point. As a result of our startup operations, which began in 1984, our year fixed base percentage of research to gross receipts is so high, at approximately 26 percent, that for the foreseeable future we will receive no R&D credit even though our R&D expenditures are approximately 13 percent of our aggregate revenues. Our inability to utilize the credit places us at a significant competitive disadvantage relative to many of our competitors. We understand, from speaking with some of those involved in putting the initial provision together in 1989, that this result was not intended.

The remedy to this technical glitch is straightforward—change the definition of a startup company to include any company with its first year of both research and development and revenues in 1984 or thereafter and to discontinue the 3-out-of-5-years' requirement.

This proposal has been endorsed by the AEA, American Electronics Association, which represents some 3,000 U.S. technology companies ranging from small startups to Fortune 100 firms. Based upon a revenue estimate given on this proposal when it was introduced in H.R. 11 in 1992, a bill that was vetoed by President Bush for reasons unrelated to this issue, the cost of this correction over 5 years was estimated to be under $50 million. I assume that the cost would be similar today.

On behalf of Xilinx and other similarly situated companies, I request that you seriously consider rectifying this problem through either a technical correction or through another form of R&D credit legislation.

Thank you again for providing me with this opportunity to share my views.

[The prepared statement follows:]

XILINX

STATEMENT OF GORDON M. STEEL

VICE-PRESIDENT OF FINANCE,
CHIEF FINANCIAL OFFICER
FOR
XILINX, INC.
SAN JOSE, CALIFORNIA

RESEARCH AND DEVELOPMENT CREDIT

BEFORE THE HOUSE WAYS & MEANS COMMITTEE
SUBCOMMITTEE ON OVERSIGHT

UNITED STATES HOUSE OF REPRESENTATIVES

MAY 10, 1995

Madame Chair and Members of the Subcommittee. My name is Gordon Steel. I am the Vice-President of Finance and Chief Financial Officer of Xilinx, Inc. Xilinx is based in San Jose, California and is the world's leading supplier of complementary metal oxide semiconductor (CMOS) programmable logic and related development system software. In March 1995, the end of our most recent fiscal year, Xilinx had approximately 850 employees worldwide, the majority of whom are located in the United States. Approximately 35% of our total revenue comes from sales made to customers outside the U.S. Founded eleven years ago, Xilinx's last fiscal year generated revenues in excess of $350 million. R&D expenses over the past ten years exceeded $150 million. Approximately 28% of our employees are engaged in R&D in San Jose, California.

I wish to thank this Subcommittee for providing me this opportunity to testify on what I consider to be a technical flaw in the R&D credit definition of start-up companies. This glitch severely impacts Xilinx as well as a few other similarly situated companies -- such as Sierra Semiconductor from California and Sequent Computer Systems of Oregon -- and has resulted in our receiving reduced credits since the credit structure was changed in 1989. In its current form, the R&D credit provision would preclude us from realizing such credit, even though our research expenditures have increased substantially each year since the inception of the company.

Xilinx was founded in 1984 by three former Zilog employees with a product concept and future vision that the R&D credit was designed to encourage. As a result of our successful R&D efforts, Xilinx had revenues in excess of $350 million for our most recent fiscal year and offers the industry's broadest selection of programmable logic devices. The success of our R&D efforts has also facilitated our annual growth in revenue, which has averaged 48% per year since becoming a public company in 1990. The first field programmable gate array (FPGA), introduced in 1985, cost $55. Today, the same part sells for $5, due in part to the research and development undertaken by Xilinx.

Before the structure of the credit was changed in 1989 and the start-up definition was written in such a way as to exclude certain start-up companies, the R&D credit was critically important to Xilinx, even though we couldn't currently use the credit dollars because of the net operating losses associated with an R&D intensive start-up operation. The credit was very important to us, nonetheless, because it reduced our effective tax rate for book accounting purposes, which in turn reduced our cost of capital. As a result, I believe that it worked as an incentive to encourage Xilinx to spend more on R&D. I further believe that the technical glitch referred to as the "notch baby issue" which prevents us from obtaining any credit is incompatible with the objectives of the R&D credit and accordingly should be corrected.

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THE TECHNICAL GLITCH AFFECTING START-UP COMPANIES LIKE XILINX

Under the current credit, only qualified research expenses over a fixed base amount are eligible for the credit. In 1989, the base calculation was changed so that the base is now computed by multiplying the ratio of a company's qualified research expenses to gross receipts for 1984-1988 by the company's average gross receipts in the prior four years.

Recognizing that companies in a start-up phase will experience a distorted relationship between research expenses and gross receipts in their initial years of operation, Congress provided a special fixed base for start-up companies. Specifically, under those rules, a start-up company is defined as any company with fewer than 3 years of both gross receipts and qualified research expenses during the base period (1984-1988).

The problem with this three out of five year test is that it affords incompatible treatment for R&D credit for those companies that began during the early years of the base period, as contrasted with those starting in the later years of that period or thereafter. Indeed, any successful company that starts selling or starts R&D in the early years of that period would not have stopped R&D spending or sales during the later years of that period. As such, any company with its first year of both gross receipts and R&D falling in 1984, 1985 or 1986 will not be considered a start-up company even though its R&D to sales ratio could have been well beyond 100% during many of the base years. We understand from those involved in putting the provision together in 1989 that this result was never intended.

Xilinx is a perfect example of the inequity exacted by this rule. Like many companies in the early to mid 80's, Xilinx was funded by venture capital. This initial capital provided the founders of the company with the resources and time necessary to develop a marketable product without the immediate need to generate revenue to cover operating costs. As a result, in the early years of operations, the company's R&D as a percentage of sales was extremely high.

Xilinx incurred its first year of research costs in 1984 and its first year of gross receipts in 1985. As a result, our four year fixed base percentage is so high (approximately 26%) that for all of the foreseeable future, we will not receive any R&D credit, even though our R&D expenditures are approximately 13% of our total revenue. Our history and our R&D to sales ratio show that we were clearly in a start-up phase and thus, were the type of company Congress intended to include in future eligibility.

Without This Change The Credit's Incentive Value is Zero For Companies Like Xilinx: We agree that the best policy goal of the credit should be to cause companies to spend more on R&D than they otherwise would without the credit. This increased R&D effort is beneficial to society because companies will be better able to bring new and more efficient technologies to society. In Xilinx's case, however, the credit doesn't work because of the technical glitch.

The Credit Actually Puts Xilinx at a Competitive Disadvantage vis-à-vis its Competitors: More importantly, the current start-up company definition puts Xilinx at a significant disadvantage when we compete with an already established company or a new company. Either of these companies will get a 20% incentive for the extra R&D they spend in developing future generations of product. We, in contrast, will not receive such assistance.

The high technology industry has evolved and changed over the years since Xilinx began business. The overriding mainstay to survival in the marketplace is having a competitive edge. Without an R&D credit, Xilinx will be at a distinct disadvantage against our competitors due to our misfortune of having our first year of sales and R&D fall in 1985 rather than in 1987 or beyond.

PROPOSAL

The proposal that would solve this problem is very simple. It would be to change the definition of a start-up company to include any company with its first year of both R&D

and sales in 1984 or thereafter. Indeed, this revised definition was included in H.R. 11 in 1992, which was vetoed by President George Bush for reasons unrelated to this issue. At the time, the cost of this fix over 5 years was estimated to be under $50 million, a cost that I would expect to be similar today.

The American Electronics Association (AEA), which represents some 3,000 U.S. technology companies ranging from small start-ups to Fortune 100 firms, has also endorsed this technical correction. I hope that you will seriously consider fixing this problem through a technical correction or through another form of R&D credit legislation to ensure that start-up companies like Xilinx who began business during the early years of the fixed base period (1984-1986) are not penalized merely for the year they were formed.

CONCLUSION

Xilinx is a perfect example of an innovative, leading edge technology company doing business in a rapidly evolving marketplace in an industry where commitment to substantial expenditures of R&D is essential. We ask that you acknowledge the oversight that resulted from the 1989 tax legislation with respect to the start-up definition. We also ask for your support in making this technical correction.

I would be happy to answer any questions you may have.

Chairman JOHNSON. Thank you very much, Mr. Steel.

How do the rest of you react to Mr. Steel's proposal?

Mr. JERNIGAN. It doesn't impact AMD, but I think it is a worthwhile proposal.

Mr. KOSTENBAUDER. At Hewlett-Packard, it doesn't impact us. We weren't involved in starting up during that 1984–88 period.

Chairman JOHNSON. Because we have heard this from a number of folks, I appreciate your being specific.

In terms of the discussion that you have heard from Members and the preceding panels, would any of you care to comment on the issue of moving to a simpler, flat tax versus retaining the incremental tax with its complexities?

Mr. JERNIGAN. I would like to comment on that.

AMD would very much support a flat tax, because with our high R&D to sales ratio of 18 percent for the last 11 years and increasing every year, the present formula is just not working; and some companies are benefiting, others are not, and I think the flat tax is the only way to be equitable to all of the companies in the country that do R&D.

It is also simple, and I think that is very worthwhile.

Mr. KOSTENBAUDER. I make the observation that for at least the limited amount of revenue that is available to fund it, the more incremental, the higher the rate; and the higher the rate, obviously the more incentive impact there can be.

On the other hand, as my testimony described, the structure of the credit as it exists has the impact of providing, at least in a number of cases, significantly greater R&E credit in cases that really do not have a lot to do with a company significantly responding to the incentive, but rather a company perhaps switching the mix of businesses in which it is already operating, or conducting its business in some other way that impacts this relationship between revenue and sales.

The point was made on another panel that today's sales have a lot to do with yesterday's R&D. I think to the extent that there is a disconnect on that point, which isn't addressed structurally, certainly moving toward a flat credit would help to ameliorate that phenomenon. Although if we can figure out a way to do it, something that keeps more of an incremental nature has the benefit of a higher rate. We don't have the final answers, but we are pleased to try to work with everyone to resolve this conundrum.

Chairman JOHNSON. Mr. Jones, in your experience in dealing with the IRS, in some of these cases wouldn't a simpler tax structure make it far easier for companies to benefit from this tax? From what I have heard today, I don't see any way we can fix the definition of what is an eligible expense. Aside from the base period issue, what is an eligible expense is very unclear to me, and I should think it would be increasingly difficult for companies to allocate expenses to innovative work versus work.

Mr. JONES. It is hard to say. In dealing with IRS controversies, I don't think the controversies arise so much over the mechanical computations and looking at the base period, but from the definitional problem. I agree that is not something that we are going to solve today or that perhaps even Congress can solve.

Some would say I am being too generous to IRS, but I really feel that to a great extent their problem has been, as the law has changed, they too have had to deal with this uncertainty. I have heard it from some within the IRS that if it isn't going to be enacted on a permanent basis, why should we continue to focus resources on it? I think permanent enactment, in whatever form, would allow the IRS to give guidance to start taxpayers to work with the IRS and make sure that everyone understands the rules.

I don't necessarily think that a flat credit is going to be any simpler in terms of tax administration. Obviously, the IRS would have to give you their opinion on that. But I suspect most of the controversy, as you have suggested, will revolve around whether or not the activity is qualified or not.

Chairman JOHNSON. Why wouldn't it be much simpler?

Mr. JONES. It would be simpler in terms of the computations. That is not the issue with the IRS. The issues and the controversies I am involved in with the IRS are whether or not a certain type of activity even qualifies.

As we have indicated in our prepared statement, it took the IRS a couple of decades to get guidance out at the very base threshold level. But again, the controversies that we see are not necessarily over the computation. It is more or less over the definitional aspects of the credit.

I know that the gentleman to my left testified about the problems with generic drugs. That is a poignant example of what has occurred to date. It is a definitional problem.

Mr. GUTMAN. I agree. It is simple to do one mathematical process, multiplying a flat number times a base. It is not much more difficult to do some averaging and then multiply numbers against a base. What is really hard is to try to figure out what is eligible for the credit. That is where we have been having the difficulty.

That is what my statement was about and my particular situation, I suspect, is not one in isolation.

Chairman JOHNSON. I certainly would hope that you would give us your thoughts on how we could simplify the terminology, what is eligible. Because the staff has helped me understand why I thought this would be a lot simpler than it is clearly going to be. But I think that a much cleaner line, if we are going to make this permanent, we have to do a better job of clarifying what is in and what is out.

Your thoughts on that would be very useful.

[The information was not available at time of printing.]

Chairman JOHNSON. Mr. Steel.

Mr. STEEL. I would agree with the previous two speakers that the administration issue would not necessarily greatly simplify the efforts involved. The problems are more like in definition and implementation.

At the risk of displaying ingratitude to the earlier two speakers, who were kind enough to support my position for tax relief for companies in the 1984–88 timeframe, I would argue slightly differently with respect to the flat rate versus the incremental. My argument would go much along the lines of Randy Capps, a previous speaker.

I suspect most employees who are serving with a rapid-growth firm would favor an incremental approach, as it probably provides

the greatest incentive to them for their overall R&D commitment. As I am sure you are aware, the incremental approach has a cap for very rapid-growth companies, 10 percent of R&D. So, clearly, in those cases where a flat tax rate would be 10 percent, that would be break-even to us if we are experiencing very, very rapid growth, but I doubt that that would be the percentage that will be seen as wise by Congress.

I also point out that employment over the last 5 years or so has been driven not so much by the Fortune 100 companies but rather by the rapid growth of small and medium-sized companies who have leveraged high technology very successfully. I believe that the most direct incentive to that future growth is to reward those rapid-growth companies by providing some additional incentive in the R&D arena.

Mr. JERNIGAN. Madam Chair, I would like to give a different perspective on the simplicity issue. I think it is more than just a mechanical simplicity.

Having a flat rate credit would also have simplicity value as far as determining what R&D is for any kind of base period—whether 1984–88, what is the R&D per year? If you move the base to a current year, you still have to determine, what is the R&D for each of those years? You are going to have to determine the sales for each of those years; you are going to have to determine the current year's sales. This has complexity, and just going to a flat credit on the current year's R&D would be much simpler, in my view.

Mr. JONES. I might add, our experience again with the IRS has been that most of the fights are over the definitional issues; and those fights, I can assure you, consume an awful lot of time and professional fees that could be more appropriately devoted to research activities. So certainly to the extent that the subcommittee and Congress can help in giving the IRS some guidance to put a little more meat on the definitional bone, that would be most helpful, and we would be glad to help in any way possible.

Chairman JOHNSON. I will appreciate your comments on the new regulations that the IRS is about to publish in this area. They promise that they will be out very soon.

Mr. JONES. The allocation issues, yes.

[The following was subsequently received:]

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September 11, 1995

The Honorable Leslie B. Samuels
Assistant Secretary (Tax Policy)
United States Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable Margaret M. Richardson
Commissioner of Internal Revenue
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

The Honorable Stuart L. Brown
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
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Attention: CC:DOM:CORP:T:R (INTL-0023-95)
Room 5228

Dear Sir or Madam:

We respectfully submit the following comments on the proposed regulations released May 19, 1995 (INTL-0023-95), governing the allocation and apportionment of research and experimental expenditures for purposes of determining taxable income from United States and from foreign sources.

The Treasury Department and IRS have long recognized the importance to the United States economy of research and experimental ("R&E") activities conducted in the United States, and the significant impact the existing provisions of the tax law governing the allocation and apportionment of R&E expenses (in determining a taxpayer's net income from United States and foreign sources) have on a taxpayer's R&E activities. The continued attention and concern of the Treasury Department and IRS is most recently reflected in the Treasury Department's report released May 19, 1995, "The Relationship Between U.S. Research and Development and Foreign Income" (the "Treasury Report"), and proposed regulations issued on that same date

(INTL-0023-95, hereinafter the "Proposed Regulations") prescribing rules governing the allocation and apportionment of R&E expenditures.

We note with approval that the Proposed Regulations would favorably modify existing regulations in several significant respects -- e.g., permitting a taxpayer to use three-digit SIC code categories in allocating its R&E expenses among its different activities, and increasing from 30 percent to 50 percent the percentage of R&E expenses that may be exclusively apportioned to income arising from the geographic location where the R&E activities are performed. Though the changes to existing regulations that are proposed are welcome, we believe certain additional modifications and clarifications are necessary to improve their efficacy. The amendments we propose are consistent with and follow upon the basic conclusions of the Treasury Report on the relationship between a taxpayer's United States R&E activities and its net foreign source income. In particular, we recommend the following changes to the proposed regulations:

1) to apply the "exclusive allocation" rule to a greater percentage of R&E expenditures,

2) to allow taxpayers to apply the optional gross income method of allocation without making a binding election,

3) to allow taxpayers the option of applying more focused SIC code categories,

4) to clarify the rules governing the treatment of a possessions corporation that has elected the profit split method under section 936(h)(5)(C)(ii) of the Code, and

5) to modify the proposed effective date in cases where a taxpayer otherwise would be unable to apply either these regulations or section 865(f).

1. The "exclusive allocation" percentage should be increased

We believe the "exclusive allocation" rule should apply to a greater percentage of R&E expenses attributable to activities performed in the United States. As the Treasury Report states, there is *considerable uncertainty* in determining the factual relationship between R&E expenses attributable to activities in the United States and foreign source income. Indeed, the Treasury Report states that there is a wide range of uncertainty, and its own estimate under the 50 percent exclusive allocation rule of the Proposed Regulations would result in an allocation of an amount that is within the range of estimates determined in the report but that is considerably above the lower end of that range.

For several reasons, we believe it is appropriate to adopt an exclusive allocation percentage that is at the lowest end of the "range of uncertainty" described in the Treasury Report. First, the Treasury Report rightly concludes that there is a high level of uncertainty in its determinations. Second, the Treasury Report's own estimation of the impact of the allocation under the Proposed Regulations would be significantly above the lower end of its range of uncertainty. Perhaps most importantly, the Treasury Report and the Congressional consideration of this issue all acknowledge the fundamental importance of United States-based R&E activities to the U.S. economy generally and the sensitivity of these activities to the effects of the tax law.

Specifically, for the reasons discussed below, we believe an exclusive allocation percentage of 64 percent is appropriate. First, a 64 percent exclusive allocation percentage has been statutorily endorsed by a prior Congress, which recognized that a reduction in U.S.-based R&E activities might adversely affect the competitive position of the United States. Congress also recognized that tax rules allocating an inappropriately large amount of R&E expense to foreign source income might unduly increase the tax cost of these activities to U.S. taxpayers -- notably, in the common circumstance where a foreign jurisdiction fails to allow the U.S. taxpayer a deduction for amounts allocated under U.S. rules to foreign source income, the foreign tax credit limitation available to the taxpayer would be inappropriately reduced. See section 11114(a) of Pub. L. 101-239; H.R. Rept. No. 247, 101st Cong., 1st Sess. 1205-1208 (1989); see also H.R. Rept. No. 795, 100th Cong., 2d Sess. 458 (1988) (A 64 percent threshold would be "consistent with tax and competitiveness policy while reducing somewhat the cost of [an earlier 67 percent threshold.]").

Second, the Baily-Lawrence study discussed in the Treasury Report and the Mansfield and Romeo data upon which it is based (also cited in the Treasury Report) conclude that a 64 percent exclusive allocation is an appropriate figure. We find the conclusions of the Baily-Lawrence study difficult to challenge, and are concerned with the arguments presented in the Treasury Report that attempt to rebut certain of the study's conclusions. For example, the Treasury Report states that the growing integration of the world economy has resulted in a decrease from that relied upon in the Baily-Lawrence study in the time lag between the introduction of technology in the United States and its introduction abroad. The Treasury Report then states that a shorter time lag would justify a smaller exclusive allocation percentage.

We are surprised by this conclusion of the Treasury Report, and find it internally inconsistent. Our own experience in high technology industries suggests that for many of the new technologies developed in the United States, the time lag between introduction in the United States and introduction abroad has actually *increased* (one of a number of examples is the fiber-optics industry). Thus, we do not believe that the Treasury Report's sweeping conclusion applies to industries in the higher end of the technological spectrum, though this determination

could be true with respect to certain industries that are not technology-intensive. The results described in the Treasury Report in this regard therefore are misleading. Moreover, the Treasury Report also states that there may be a *longer* lag in the application of R&E to foreign income than to domestic income. Though this statement appears directed at the lag in the realization of a return on technology outside the United States rather than the introduction of technology outside the United States, as a blanket statement it cannot be reconciled with the Treasury Report's determination that a globalized economy would lead to a shorter lag in the introduction of technology abroad.

The foregoing discussion illustrates a fundamental flaw in the Treasury Report and the evidence upon which it relies -- namely, the Treasury Report fails to distinguish between the application of R&E activities of high technology versus low technology industries. In the latter case, we believe that R&E expenditures are likely to be low. Including these industries in the figures relied upon in the Treasury Report's "Estimating the Domestic Return to U.S. R&D" results in grave distortions. To a certain extent the Treasury Report acknowledges these distortions, noting in its discussion of its principal and alternative methodologies that computing a return on domestic R&E is subject to "substantial error." The substantial error is illustrated by the very numbers the Treasury Report presents: it states that for 1990 the domestic R&E expenditures amounted to $63.5 billion, yet projects a range of return on this investment the low end of which is $104.8 billion, which we believe is an unusually modest projection. This projection may indeed factor too heavily the impact of low R&E industries that distort the true economic impact of R&E activities generally.

These uncertainties, inconsistencies, and possible substantial errors preclude any sort of substantial reliance on the range of results projected by the Treasury Report in its Table I. Instead, these figures must be adjusted to accommodate more fully the imperfections of the methods to avoid any undue economic impact on this critical U.S. activity. Accordingly, we believe the range of results should appropriately be expanded to include an allocation that utilizes an exclusive apportionment of at least 64 percent.

2. The optional gross income method election should not be binding

The Proposed Regulations dictate that the optional use of the gross income method of allocation is available only if the taxpayer makes an election *binding* on the taxpayer for all subsequent years unless revoked with the consent of the Commissioner. Prop. Reg. section 1.861-8(e)(3)(iii)(C). The requirement that the gross income method is available only by making a binding election represents a significant limitation on the ability of taxpayers to manage effectively the tax cost associated with their R&E expenditures. As noted above, the Treasury Report itself emphasizes the considerable uncertainty associated with the determination of the factual relationship between R&E activities conducted in the United States and foreign source

income. The dictate that taxpayers make a binding election for apportioning expenses under the gross income method forces taxpayers to commit to a position involving an allocation of expenditures for which the tax effects are profound, but whose policy base is uncertain. Moreover, this position is inconsistent with the Treasury Report's acknowledgment of this uncertainty. Accordingly, we recommend deletion of the binding election requirement, and propose instead to allow taxpayers annually to choose to apply the gross income method of allocation, which would be entirely consistent with the existing regulations.

3. Taxpayers should be permitted the option of applying more focused SIC codes

In dividing a taxpayer's R&E expenses among its different product categories, the Proposed Regulations provide that the taxpayer may determine its relevant product categories by reference to the three digit SIC code. This refines the provisions of existing regulations limiting the allocation to product categories determined by reference to the two digit SIC codes, and prohibiting any subdivision of categories. It is unclear from the language of the Proposed Regulations, however, whether application of the three digit code is mandatory where it is available, or if the two digit SIC code may otherwise be used. See seventh and eighth sentences of Prop. Reg. section 1.861-8(e)(3)(i)(B). It is appropriate to allow taxpayers flexibility in determining the specificity with which it may define its product categories. Therefore, we urge that the proposed regulations be clarified to permit taxpayers to choose whether to utilize the two digit SIC code.

Consistent with this view, it also would be appropriate to allow taxpayers that have information sufficient to allow them to define a product category by reference to a more specific SIC code (i.e., of four, five or greater digits) to choose those product categories, so long as the taxpayer's method is consistent from year to year and cannot be changed without the Commissioner's approval (as provided in the Proposed Regulations).

4. Taxpayers electing section 936 profit split method should be allowed corresponding adjustments

Stated broadly, Prop. Reg. section 1.861-8(e)(3)(i)(C)(2) provides that sales and gross income from products produced in whole or in part by a possessions corporation will not be taken into account in allocating and apportioning R&E expenditures. Prop. Reg. section 1.861-8(e)(3)(i)(C)(3) provides that the R&E expenses taken into account for purposes of these provisions must be reduced by the amounts included in computing the cost-sharing amount of the possessions corporation under section 936(h)(5)(C(i)(I). A reduction is necessary to avoid double counting the same expenses -- once in reducing the allowable income of a possessions corporation and a second time in reducing the parent company's foreign source income. Where the possessions corporation subsidiary has elected the profit split method prescribed in section

936(h)(5)(C)(ii), however, the proposed regulations appear to require this improper double counting. This arises because the combined taxable income computed under the profit split method must be reduced by 120 percent of the applicable product area research expenses incurred by the parent corporation. To the extent the allowable income of the possessions corporation subsidiary has been reduced pursuant to this rule, it would be appropriate for the Proposed Regulations to prescribe a rule reducing by a corresponding amount the R&E expenditures taken into account under Prop. Reg. section 1.861-8(e)(3).

5. Effective date should be amended to cover taxpayers otherwise excluded from both these regulations and section 865(f)

Section 864(f), which prescribes a 50 percent exclusive allocation rule under both the sales and the gross income methods, is generally applicable for a taxpayer's first taxable year beginning on or before August 1, 1994. The effective date of the Proposed Regulations is proposed to be for taxable years of a taxpayer beginning after December 31, 1995. See Prop. Reg. section 1.861-8(e)(3)(vi). The Proposed Regulations would allow a taxpayer to choose to apply the regulations instead to its taxable year beginning after December 31, 1994. In spite of this option, however, there remains a gap in timing under which a taxpayer whose taxable year begins after August 1, 1994 but before January 1, 1995 can apply NEITHER the provisions of section 864(f) NOR those of the Proposed Regulations. We therefore urge that the optional effective date of the Proposed Regulations be amended to extend to taxpayers whose taxable years began after August 1, 1994.

We appreciate the opportunity to offer comments on the Proposed Regulations. If you have any questions on these comments or would like to discuss them further, please contact Nilesh Shah (714-850-4317) or Larry DeLap (415-354-4016).

Respectfully,

KPMG Peat Marwick LLP

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cc: Benedetta Kissel, Acting Associate Chief Counsel (International)
Joseph Guttentag, International Tax Counsel

Mr. GUTMAN. If I could make one comment, what I think you are hearing now and what you have heard this morning is an illustration of an important tension that exists in terms of trying to determine where the subsidy should go, how you determine whether it is going into the right place, and what is good and bad R&D.

To the extent that the statute is less rather than more precise, the IRS is the entity that has to make that decision, and the kinds of difficulties that we encounter in practice come because the IRS is forced to make these kinds of decisions. Sometimes they make them in a way that is correct, sometimes probably against congressional intent; but the difficulty, I think, is endemic and has to be faced. When you are going to legislate this kind of incentive you have to decide the scope of the incentive and then who will decide who is entitled to it. That is a difficult tension.

Chairman JOHNSON. I agree. I have seen this subcommittee go through those kinds of rethinking processes and struggle with those very issues. I would say that I want the subcommittee to go through that again on this.

On the other hand, because of the overriding importance of permanence, if there is one message that has been consistent, it is that we have to make it permanent; and it may be that because of our process, that will be all we can handle.

Mr. GUTMAN. I understand that. I think that is very important.

Chairman JOHNSON. I would like to bring to the committee a greater depth of discussion, or at least to the subcommittee.

I have a vote. I will run over and vote. If the last panel will assemble, I will be right back. Thanks.

[Recess.]

Chairman JOHNSON. Thank you very much. The hearing will reconvene.

Mr. Warren of TRW.

STATEMENT OF WILLIAM A. WARREN, VICE PRESIDENT, TAX, TRW, INC., CLEVELAND, OHIO, ON BEHALF OF ELECTRONIC INDUSTRIES ASSOCIATION

Mr. WARREN. Madam Chair, I am William Warren, vice president of Tax for TRW, Inc. TRW is a U.S. company, based in Cleveland, Ohio, which provides advanced technology and worldwide products for the automotive, space, and defense markets. I am here today representing the EIA, Electronic Industries Association. EIA represents over 1,000 members involved in the manufacture of electronic components for communications, industrial, government, and consumer end uses.

Today, U.S. companies compete on a global basis. A sound R&D tax policy is essential if U.S. companies are to compete effectively in the global marketplace. A permanent and effective R&E tax credit is essential to this policy, along with a permanent and fair resolution of the continuing controversy on the section 861 R&D allocation rules.

Since its inception, the R&E tax credit has provided a valuable economic incentive for U.S. companies to increase their investment in R&D in order to maintain their competitive edge in the global marketplace and to keep that R&D in the United States. On the margin, $1 of credit stimulates as much as $2 of additional R&D

spending in the long run, but this incentive effect is reduced because of lack of permanence.

At TRW, for example, we hold a leadership position on automotive safety systems such as air bags. The technology evolves rapidly and we compete with many non-U.S. companies. Our technology has led to major investments in the United States and thousands of U.S. jobs. However, despite our success to date, we must continue to invest in new R&D, and that new R&D must always have uncertain returns. Further, these high-risk R&D dollars must compete internally with other global capital budget opportunities. A permanent and effective R&E tax credit is needed in this environment.

For many EIA companies, the current credit is very effective. However, for some, such as TRW, structural reform would be very helpful. Space technology products, for example, used to be over 50 percent of our business; due to a downsizing of that segment, it is now about 40 percent. However, our historically high levels of space technology research continue to be reflected in the 1984–88 base period component of the credit calculation, which then restricts the deliverability of the credit on current automotive research.

Permanence is a first priority. However, we urge the Congress to address these structural reform needs.

The last issue is the allocation of U.S.-based research expense for Federal tax purposes. Under the section 861 regulations, first issued in 1977, U.S.-owned research-intensive companies with foreign operations are required to treat a significant portion of their U.S. R&D as if the research was, instead, conducted offshore for purposes of determining foreign tax credits. These arbitrary allocations create a bias against U.S.-based research and against U.S.-owned companies competing in this global environment.

In my experience, I have found no foreign country that allows a tax deduction for this research, which has, in fact, been conducted right here in the United States. Consequently, these U.S. companies effectively lose the benefit of a deduction for a significant segment of their U.S. R&D. Thus, American companies with U.S. R&D successfully competing in global markets are penalized. It also creates a competitive disadvantage for those U.S.-owned companies. U.S. tax rules should not put any U.S.-owned companies at such a disadvantage.

Absent relief, the only way to ensure full deductibility would be to perform the research in a foreign country. Of course, movement of such research abroad would be contrary to American economic interests, so the Congress has periodically and rightly imposed moratoriums on these 1977 rules.

Treasury has recently indicated that the 1977 rules in question are under review, which may lead to a permanent regulatory solution. However, if not, we ask this subcommittee to support a permanent legislative moratorium on the 1977 regulations using the so-called "64-percent solution" which has been previously enacted.

We appreciate the support of past congressional leadership in urging Treasury to resolve the section 861 R&D allocation issue. We urge the Congress to continue this support. We also need a permanent R&E tax credit to keep us competitive and, again, permanence is our No. 1 priority.

Thank you very much.

[The prepared statement follows:]

STATEMENT OF WILLIAM A. WARREN
VICE PRESIDENT, TAX, TRW, INC.
ON BEHALF OF ELECTRONIC INDUSTRIES ASSOCIATION

My name is William A. Warren. I am Vice President of Tax for TRW Inc. TRW is a U.S. company based in Cleveland, Ohio, which provides advanced technology products and services for the automotive, space and defense, and information markets on a worldwide basis.

I am here today representing the **Electronic Industries Association (EIA).** EIA is the industry's oldest, full service national trade association for the electronics industry, comprised of more than 1250 companies involved in the design, manufacture, distribution and sale of electronic components, equipment and systems for consumer, commercial, military, industrial and space use. Overall, the industry was responsible for more than $340 billion in factory sales in 1994, of which approximately 30% were export-oriented.

THE NEED FOR PERMANENT RESEARCH & DEVELOPMENT INCENTIVES

EIA believes that broad-based research and development incentives are good policy because they allow the marketplace to continue to drive the decisions as to what types of research and development are needed to help the nation stay competitive. R&D spending by U.S. firms has improved from the low levels of the late 1970s -- in part, we believe, because of the R&D tax credit's impact.

However, most of the major industrialized European and Asian countries as well as Canada offer various R&D related tax and financial incentives to assist native companies and to encourage foreign companies to locate R&D projects within their borders. These incentives lower the cost of R&D in these foreign countries and provide foreign companies competitive advantages over U.S. industries absent similar U.S. research and development incentives.

Indeed, EIA believes the high rates of R&D in other nations underscore the success these nations have had in fashioning successful national strategies --- including tax policies -- which advance their own technology-based industries' global competitiveness.

A sound research and development tax policy is essential if U.S. companies are to compete effectively in the global marketplace. A permanent and effective R&E tax credit is critical to this policy along with a permanent and fair resolution of the continuing controversy on the section 861 R&D allocation rules.

R & D TAX CREDIT

Since its inception the R&D credit has provided a valuable economic incentive for U.S. companies to increase their investment in research and development in order to maintain their competitive edge worldwide. A permanent R&D credit is critical to research-intensive companies such as those in electronics and to encourage U.S. industry to continue research and development activities in the U.S. rather than moving them offshore. On the margin, one dollar of the R&D credit stimulates as much as two dollars of additional R&D spending in the long-run. However, the incentive effect is reduced because of its lack of permanence; corporate decisionmakers are hesitant to factor in the credit's benefits due to the uncertainty over the long-term availability of the credit.

For example, at TRW, we hold a leadership position on automotive safety systems such as air bags. The technology for these products evolves rapidly, and we compete with many non-U.S. companies. Our technology has led to major investments in the U.S. and thousands of U.S. jobs. However, despite our success to date, we must continue to invest in new R&D and that new R&D will always have uncertain returns. Further, these new high-risk R&D dollars must compete with many other global capital budget opportunities within the company. A permanent and effective R&E tax credit is needed in this environment. This is true for all research-intensive, U.S. companies -- the credit can make the key difference.

For many EIA companies, the current credit is very effective; however, for some such as TRW, structural reform of the credit would be helpful. Space technology products used to be 50% of TRW's business. Due to downsizing of that segment, it is now about 40% and declining. However, our historically high levels of space technology research continue to be reflected in the 1984-88 base period component of the credit calculation which then restricts the deliverability of the credit on current automotive research. Permanence is a first priority. However, we urge the Congress to study and address these structural reform needs.

SECTION 861 ALLOCATION RULE

The last issue is the allocation of U.S.-based research expense for federal tax purposes. This issue spans an 18-year period of continuing controversy. Under the section 861 regulations, issued in 1977, U.S.-owned, research-intensive companies with foreign operations are required to treat a significant portion of their U.S. research expense "as if" the research was instead conducted offshore for purposes of determining foreign tax credits. These arbitrary allocations create a bias against U.S.-based research and U.S.-owned companies competing in a global environment. In my experience, no foreign country allows a tax deduction for this research which has, in fact, been conducted in the U.S. Consequently, these U.S. companies effectively and economically lose a deduction for the expenditures and are exposed to international double taxation to the extent they have excess foreign tax credits. In effect, a penalty is directed at those American companies performing substantial U.S. R&D and successfully competing in global markets; and yet both of these characteristics are highly beneficial to the U.S. economy and crucial to the growth of the high-tech companies that comprised EIA.

The only way to ensure that such expenses receive full deductibility would be to perform the research in the foreign country rather than in the U.S. Of course, movement of such research abroad is counterproductive to American economic interests. Recognizing this, the Congress has periodically imposed a complete or partial moratorium of the 1977 regulatory rules.

In addition to being an incentive for the movement out of the U.S. of U.S.-based R&D, the section 861 rule imposes a competitive disadvantage on those U.S. owned companies subject to the rules. Consider for a moment two multi-national companies, one U.S.-owned and one foreign-owned, and both investing in new R&D. To focus on the effects of 861, assume that the two companies have identical U.S. operations -- same investment, cost structure, products, technology, management, workforce, and the same level of U.S.-based R&D. The U.S.-owned operation would carry a higher tax burden than the foreign-owned U.S. operation due to section 861 and would be at a serious competitive disadvantage relative to the foreign-owned competitor -- a disadvantage which would grow each year solely as a result of the section 861 R&D allocation provisions. Further, to the extent the foreign-owned competitor conducts its research outside the U.S., it would again enjoy full deductibility in its home country. Again, by comparing this to the U.S.-owned company, we can see that a competitive disadvantage is created by U.S. tax rules against many U.S.-owned companies.

Surely U.S. tax rules should not put any U.S.-owned companies at such a disadvantage for R&D located in the U.S. Growing U.S. research is critical to U.S. economic growth. This requires a permanent and fair solution to the issue of the allocation of U.S.-based research expenses.

Thus, just to reiterate this key point, American companies with U.S. R&D, successfully competing in global markets, are penalized. It also creates a competitive disadvantage for those U.S.-owned companies relative to U.S. and foreign competitors not subject to these reallocations. U.S. tax rules should not put any U.S.-owned companies at such a disadvantage.

Absent legislative or regulatory relief, the only way to ensure that such expenses receive full deductibility would be to perform the research in a foreign country rather than in the U.S. Recognizing that movement of such research abroad is counterproductive to American economic interests, the Congress has periodically and rightly imposed a complete or partial moratorium on the 1977 rules.

Recently, Treasury has indicated that the 1977 rules in question are under review. We hope this will lead to a permanent, satisfactory regulatory solution which will eliminate the continuing controversy. Treasury certainly has the authority to resolve these issues, and we hope this committee and the congressional leadership will urge Treasury to exercise that authority. However, if a regulatory solution is not forthcoming, we ask this committee to support a permanent legislative moratorium on the 1977 regulations and impose the so-called "64% percent solution" which has been previously enacted in response to this issue.

CONCLUSION

In closing, on behalf of the Electronic Industries Association I thank you for the opportunity to testify before the committee today. EIA urges you and your fellow committee members to make permanent the R&E tax credit to keep us competitive in this global economy, to drive the creation of new technology and to make us a more productive America in the years ahead.

We also appreciate the support of the past congressional leadership in urging Treasury to resolve the section 861 R&D allocation issue administratively. We urge this Committee and the Congress to continue this support in order to find a joint and permanent solution to this continuing controversy.

Chairman JOHNSON. Thank you. Now my earlier mistaken comment is not relevant. We will be interested in your reaction to those regulations that are due out any time and see if they solve some of the problems. We have been led to believe they will.

Mr. WARREN. Would you like comments now or later?

Chairman JOHNSON. Later. They are due out any day. So when they come out, we will look at that before we decide how to move in this area. So if you will get back to us when you see that, that goes for anyone whose interests are in this area.

[The following was subsequently received:]

Electronic Industries Association

September 6, 1995

Commissioner Margaret Richardson
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D. C. 20114

Attn:CC:DOM:CORP:T:R (INTL-0023-95)

Re: Proposed Regulation Section 1.861-8(e)(3)

Dear Commissioner Richardson:

I am writing on behalf of the Electronic Industries Association (EIA) in response to the Notice of Proposed Rulemaking published in the Federal Register on May 24, 1995 (60 Fed. Reg. 27453) relating to proposed regulations concerning the allocation and apportionment of research and experimental ("R&D") expenditures for purposes of determining taxable income from sources within and without the United States (hereinafter referred to as the "Proposed Regulations").

EIA is the industry's oldest, full service national trade association for the electronics industry, comprised of more than 1250 companies involved in the design, manufacture, distribution and sale of electronic components, equipment and systems for consumer, commercial military, industrial and space use. Overall, the industry was responsible for more than $340 billion in factory sales in 1994, of which approximately 30% were export-oriented.

EIA commends Treasury's efforts in reexamining the proper allocation and apportionment of deductions for U.S. based R&D expenditures to foreign income, Treas. Reg. *Sec.* 1.861-8(e) (the "1977 Regulations"). There has been a great deal of uncertainty regarding the proper allocation and apportionment of deductions for U.S. based R&D expenditures to foreign income for more than 17 years. EIA supports a permanent resolution to this issue and believes that the Proposed Regulations represent a significant step in the right direction.

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EIA is pleased with a number of technical decisions underlying the Proposed Regulations including:

1) The decision to conform the treatment of the Section 936 and R&D allocation rules with the former section 864(f) rules, which provided that the R&D expenditures taken into account under the allocation rules should be reduced by amounts taken into account under either the cost sharing or profit split method computed under section 936(h)(5)(C). EIA believes that to fully achieve that result, the language of the Proposed Regulations should be explicitly modified to clarify that the reduction in R&E expenditures provided by Prop. Reg. S 1.861-8(e)(3)(I)C)(3) applies when the taxpayer has elected either the cost sharing or the profit split method under section 936(H)(5)(C).

2) EIA was pleased with Treasury's decision not to adopt the so-called "goose-to-gander" provision included in section 864(f) of the Internal Revenue Code of 1986, as amended (the "Code"), because that provision failed to recognized the greater impact of parent country affiliation on commercialization of R&D. EIA feels the rule in the Proposed Regulation achieves a more accurate matching of income and expense.

EIA believes that the Proposed Regulations are a substantial improvement over the 1977 regulations; however, EIA believes that the Proposed Regulations must be further improved, particularly to afford some tax relief to companies that utilize the gross income method. Absent such relief these companies effectively remain under the 1977 regulations.

EIA recommends that the Proposed Regulations be amended to address the following points. First, the exclusive apportionment provision applicable to the gross sales method of apportionment should be expanded to include the optional gross income method of apportionment. Second, taxpayers should not be required to make a binding election in order to use the gross income method. Third, although the proposed regulations adopt the three digit (rather than two digit) SIC code grouping rule allowing certain taxpayers to avoid allocating U.S. research to foreign income that is truly unrelated to that U.S. research, we suggest that further relief is warranted for taxpayers that have worldwide product lines in the same three digit SIC code but the products by geographical region are sufficiently different that non-U.S. R&D is both necessary and appropriate. For these taxpayers with significant non-U.S. R&D, further allocations of U.S. R&D is inappropriate. Lastly, that the effective date of the Proposed Regulations should be modified to cover fiscal year taxpayers whose taxable years begin after August 1, 1994 but before January 1, 1995.

1) In order for all taxpayers to avoid the potential of double taxation, allocations of R&D expenditures should be based solely on each taxpayer's facts and circumstances. The 1977 Regulations acknowledged that due to differences in facts and circumstances, some taxpayers

could reduce their exposure to double taxation by use of the gross sales method and others through use of the gross income method. Treasury should maintain consistency in this matter (i.e., such as Rev. Proc. 92-56, 1992-2 C.B. 409) by permitting those taxpayers on the gross income method to exclusively apportion their R&D expenditures on the same basis as taxpayers who use the gross sales method of apportionment.

2) The requirement in the Proposed Regulations that taxpayers who elect to apportion R&D expenditures on the optional gross income method are bound to use such method in future taxable years ignores both the aforementioned differences in taxpayers' facts and circumstances and the basic tenet espoused by both Treasury and the Congress of reducing taxpayers' exposure to double taxation by allowing the taxpayer the choice of either the gross sales method or gross income method. It is not even clear from the related Treasury study why the binding election rule was adopted in the proposed regulations. The gross income method is an acceptable method, and as such, should not be burdened by extra requirements not placed on the other acceptable method. Taxpayers should be entitled to choose each year the method of apportionment that best reduces the potential for double taxation. There is no tax advantage to taxpayers who elect to apportion R&D expenditures on the basis of gross income in one year and then on the basis of gross sales the next; such taxpayers are merely reducing the real cost of double taxation.

3) There is a lack of clarity of what is normally referred to as the facts and circumstances test for special allocations. EIA would suggest that you consider some method of relief in these areas both from a tax policy point of view as well as a competitiveness issue in a global marketplace. Specifically we propose that you address this area by defining a bright line test by three digit SIC code. Under this method, if the ratio of foreign R&D in a three digit SIC code of all foreign affiliates of a U.S. consolidated group over foreign affiliate sales in that SIC code exceeds 50% of the ratio of U.S. consolidated R&D in that SIC code to consolidated group sales in the same SIC code, then the U.S. consolidated group R&D would be exclusively (100%) allocated to U.S. source income. For any three digit SIC code group which does not meet this test, the normal 50% allocation followed by a sales method apportionment would then apply with comparable adjustments for taxpayers on the gross income method. Incorporation of this test in the regulations would permit taxpayers with extensive foreign R&D to properly avoid inappropriate allocations and apportionments of U.S. R&D to foreign source income.

4) The effective date of the Proposed Regulations is for taxable years beginning after December 31, 1995, although the regulation gives taxpayers the option of electing to apply the regulation for taxable years beginning after December 31, 1994. This effective date permits calendar year companies to apply the new regulation to their first taxable year beginning after the regulation's latest moratorium. Fiscal year companies whose taxable years begin after August 1, 1994, but before January 1, 1995, however, will suffer a one year "gap" during which

the 1977 Regulations will apply because the last extension of the moratorium on the 1977 Regulations applied to the first taxable year beginning on or before August 1, 1994. Section 864(f)(6) of the Code, as amended by the OBRA OF 1993.

Although the gap in the effective date provisions of section 864(f)(6) of the Code and the Proposed Regulations may only be an oversight, it needs to be corrected in order to prevent unfair results to fiscal year taxpayers whose taxable years began after August 1, 1994, but before January 1, 1995.

Thank you in advance for considering these comments.

Sincerely,

Donna Siss Gleason

Donna Siss Gleason
Director
Government Relations

Chairman JOHNSON. Mr. Sinaikin.

STATEMENT OF RONALD A. SINAIKIN, VICE PRESIDENT, TAXES, ALLIEDSIGNAL, INC., MORRISTOWN, N.J., ON BEHALF OF THE CHEMICAL MANUFACTURERS ASSOCIATION

Mr. SINAIKIN. Thank you, Madam Chair. I am Ronald Sinaikin, vice president of Taxes, AlliedSignal, Inc. I am appearing on behalf of the CMA, Chemical Manufacturers Association. I am going to summarize our written statement which I ask be included in full in the hearing record.

CMA welcomes this opportunity to present the views of the U.S. chemical industry on the research credit and on the allocation of research and development expenses. Our member companies represent more than 90 percent of America's productive capacity for basic industrial chemicals. Since 1991 the chemical industry has been the Nation's leading exporter with an estimated $50 billion in exports and a net trade surplus of $18 billion in 1994.

The chemical industry also ranks first among all U.S. manufacturers, with an estimated $18.1 billion in research and development spending in 1994. Our industry is an excellent example of how a strong research effort can develop new products and increased productivity to help overcome high labor and capital cost disadvantages.

Over time, the U.S. chemical industry has shifted from the production of basic commodity chemicals to the production of new specialty chemicals. Our industry has changed fundamentally, but it continues to provide high technology, high-wage jobs for more than 1.1 million U.S. workers and continues to be a strong, positive contributor to the U.S. trade performance.

On several occasions, CMA has supported extending and improving tax incentives for U.S. research and development. Without them, the competitiveness of both the United States and the U.S. chemical industry will decline. Other industrial nations offer strong incentives for research. The nations that develop new science and technology are normally those in which the new technology will first be employed and new plants and jobs will be created.

In addition, tax incentives for research offer an appropriate means to offset our competitive disadvantages of high labor and capital costs. Because research programs require long lead times, short-term extensions of the research credit will not achieve the full economic incentive of a permanent extension. At a minimum, Congress should adopt the permanent research credit now.

It should also be recognized that many companies that have strong research programs do not benefit from the present research credit. That is because the credit applies on an incremental basis. Our statement outlines several common fact patterns under which a company may not receive the research credit even though it maintains or increases its actual expenditures for research. We urge that you either amend the existing research credit or develop an alternative that will be available in those circumstances.

CMA also supports a permanent solution to the 18-year controversy over the Treasury's R&D expense allocation rules. The Treasury allocation rules work at cross-purposes with the research credit. A company can be eligible for the credit for its research ac-

tivities, but through the operation of the allocation rules, the company could effectively be denied a deduction for its research expenses.

The real economic effect of the allocation rules is to disallow any deduction for expenses of research conducted in the United States after the company is in an excess foreign tax credit position. For these companies, that could significantly increase the cost of conducting research in the United States. It makes no sense for the U.S. tax system to increase the cost of conducting research in America under any conditions.

CMA has testified since 1983 that the allocation regulations would undermine the effectiveness of the research credit. On at least seven occasions, Congress has enacted statutory moratorium to prevent allocation under the 1977 regulations. That is persuasive evidence that those regulations were ill advised. It is time to end the 18 years of controversy.

The most rational solution is for the U.S. Treasury Department to adopt a permanent allocation rule which, at a minimum, is similar to the most recent moratorium. In the alternative, Congress should enact legislation to achieve that result. Hopefully, we will see in a couple of days if Treasury did do that.

As a nation, America needs a strong private sector research establishment located in the United States. As we have testified, it is a source of the new technologies needed for continued economic growth and productivity that will provide new American jobs and higher living standards.

That concludes my oral statement. I will be happy to answer any questions.

[The prepared statement follows:]

STATEMENT OF
RONALD A. SINAIKIN
VICE PRESIDENT, TAXES
ALLIEDSIGNAL INC.
ON BEHALF OF THE
CHEMICAL MANUFACTURERS ASSOCIATION
ON THE
RESEARCH AND EXPERIMENTATION TAX CREDIT AND THE
ALLOCATION OF RESEARCH EXPENSES UNDER I.R.C. § 861
SUBMITTED TO THE
SUBCOMMITTEE ON OVERSIGHT
OF THE
COMMITTEE ON WAYS AND MEANS
MAY 10, 1995

SUMMARY OF PRINCIPAL POINTS

1) Research and development activities form the basis for new products, new markets, and increased economic productivity and living standards. Without these activities the United States becomes noncompetitive. The U.S. chemical industry – a high tech industry – would be particularly disadvantaged.

2) Other nations offer strong incentives for research, recognizing that these activities develop new science and technology. Research sites importantly influence the location of the plants in which the new technology will be employed.

3) CMA, accordingly, supports a permanent research tax credit. Because research programs require long lead times, short-term extensions of the research credit will not have the full economic incentive of a permanent extension.

4) Many industries that maintain important research and development programs do not benefit from the present incremental research credit. Congress should consider providing an alternative research credit for firms that conduct important research activities but that have not expanded those activities rapidly enough to qualify for the incremental research credit.

5) It also should be recognized that Treas. Reg. 1.861-8(e)(3) allocation rules work in direct opposition to the research credit. The practical impact of these regulations is to deny any deduction for research and development expenses after a company is in an excess foreign tax credit position.

6) National Science Foundation data continue to provide strong evidence that U.S. corporations are increasingly conducting research activities abroad.

7) It is time to end the 18 years of controversy over the allocation of research expenses between U.S. and foreign source income. Enacting a permanent allocation rule similar to the most recent moratorium would encourage the conduct of research activities in this country. This allocation should also be used to compute the allowable export incentive under the Foreign Sales Corporation ("FSC") provisions.

The Chemical Manufacturers Association (CMA) is a nonprofit trade association whose member companies represent more than 90 percent of the productive capacity of basic industrial chemicals within this country. We welcome this opportunity to submit the views of the U.S. chemical industry on (1) the importance of extending the research and experimentation tax credit ("research credit") before it expires on June 30, 1995, and the need to make the research credit permanent; and, (2) the need for a legislative solution for the current law rules requiring the allocation of expenses for research and development conducted in the United States between U.S. and foreign source income.

The U.S. chemical industry has a vital interest in the continuing search for ideas that will contribute to future expansion of productive capacity and new job opportunities in the United States. In 1994, our industry spent an estimated $18.1 billion for research, more than twice the amount expended in 1984. Moreover, the chemical industry ranks first among all U.S. manufacturing in research and development spending.

Over the past several years the U.S. chemical industry has been shifting from production of basic commodity chemicals toward production of new specialty chemicals that have evolved from continuing research and development. Research and development is also important to the U.S. chemical industry not only because it leads to the discovery of new, patent protected products, but because it leads to increased productivity which can overcome labor and capital cost disadvantages.

Although the fundamental nature of the U.S. chemical industry is changing, it continues to provide high-tech, high-wage jobs for more than 1 million U.S. workers. Moreover, the chemical industry continues to be a strong positive contributor to U.S. trade performance. As you know, our nation's merchandise trade balance in 1994 showed a $151.3 billion deficit, but exports of chemicals totaled $51.5 billion and exceeded imports by $18.3 billion. The strong export position of the U.S. chemical industry is, however, very much dependent on maintaining the productivity gains and stream of new products that derive from a large, effective private sector research effort.

On several occasions over the past 15 years, CMA has appeared before this committee to support the extension and improvement of tax incentives for U.S. research and development. The reason for these incentives is fundamental: research and development activities form the basis for new products, new markets, and increased economic productivity. Without these activities, the competitiveness of both the United States and the U.S. chemical industry will decline. For valid reasons, industrialized nations typically offer strong incentives for research and experimentation expenditures. Nations that develop new science and technology are normally those in which the new technology will be first employed and new plants and new jobs will be created. Since U.S.-based production has relatively high labor and capital costs, incentives for research and development offer the most appropriate means to offset these competitive disadvantages.

The research credit was enacted in 1981 to provide these incentives. But let us consider its history to date.

In 1981 the research credit equaled 25 percent of the excess of qualified research expenses in the current year over a moving average of such costs in the three prior taxable years. That research credit expired in December, 1985, but the Tax Reform Act of 1986 retroactively extended it on a modified basis through 1988. The 1986 legislation reduced the research credit rate from 25 percent to 20 percent, tightened the definition of qualifying expenses and modified the university basic research credit. The Technical Amendments and Miscellaneous Revenues Act of 1988 extended the research credit at 20 percent through December 31, 1989. The Act also reduced the deduction under Section 174 for qualified research expenses by an amount equal to 50 percent of the research credit for that taxable year. The Omnibus Budget Reconciliation Act of 1989 extended the research credit through December 31, 1990, replaced the moving average base period with a fixed-base percentage, and increased the Section 174 deduction disallowance to 100 percent of the research credit claimed for that year.

In the Omnibus Budget Reconciliation Act of 1990, Congress extended the research credit through December 31, 1991. The credit was subsequently extended to June 30, 1992, in the Tax Extension Act of 1991. Most recently, the Omnibus Budget Reconciliation Act of 1993 extended the research credit from July 1, 1992 until June 30, 1995.

CMA believes that the research credit should be improved and made permanent and has consistently expressed this position since 1981. The credit has contributed significantly to the continuation and expansion of research programs in general (cf. the 1994 study "Extending the R & E Tax Credit: The Importance of Permanence," by R.G. Penner, L.C. Smith, and D.M. Skanderson of the Policy Economics Group, KMPG Peat Marwick), and to the health and prosperity of the United States chemical industry in particular. The chemical industry has a vital interest in the continuing search for ideas which will contribute to future expansion in new technology, processes, production, and the development of new job opportunities in this country. The industry is in the forefront of U.S. research-oriented activities.

As a nation, we need a strong private sector research establishment. New technology is a primary source of continued economic growth and the basis for future increases in productivity and living standards. It is imperative that U.S. policy encourage domestic research activity. Research programs typically require long lead times, and the uncertainty about the future that results from short-term extensions of the research tax credit are detrimental to new research programs.

CMA believes that a permanent extension of the research credit would be a significant start on the job that needs to be done. At a minimum, Congress should adopt a permanent research credit now. Until that is done the real economic incentive the research credit can provide is substantially reduced.

It should be recognized that many companies that have made substantial contributions to the U.S. economy by maintaining strong research and development programs do not benefit from the present research credit. That is because the research credit currently applies on an incremental basis. The research credit is available only to the extent the taxpayer's current year ratio of research and development expenses to sales exceeds the same ratio for the base period 1984-1988.

Moreover, a company may not be eligible for the research credit even though it maintains or increases its actual expenditures for research. Regrettably, this can occur in several common fact patterns:

o A rapid increase in sales could adversely affect the company's ratio of research expenses to sales.

o A company develops new product lines that are not research intensive, thus lowering its overall ratio of research expenses to sales.

o To meet international competition, many companies have been forced to reduce their work force, thus lowering the overall ratio of research expenses to sales.

In each of these illustrations a company could be denied the research credit for reasons that are totally unrelated to its research efforts. Thus, Congress should consider providing an alternative research credit that would be available to these firms that conduct important research activities, but that have not expanded those research activities rapidly enough to qualify for the incremental research credit.

CMA also strongly believes that a permanent solution to the almost 18-year controversy over Treas. Reg. 1.861-8 (e)(3), the research and development ("R & D") expense allocation rules, is also critically needed. Treas. Reg.1. 861-8 (e)(3) works at cross purposes with the research credit because it provides a disincentive to conduct research in the United States.

Since 1981, Congress has adopted a statutory moratorium on seven occasions to prevent the allocation of R & D expenses between U.S. and foreign source income that

otherwise would be required under Treas. Reg. 1.861-8(e)(3). These include amendments to ERTA (1981), DEFRA (1984), COBRA (1985), Tax Reform Act (1986), TAMRA (1988), OBRA (1990), and OBRA (1993). In addition, in 1992 the chairmen of the House Committee on Ways and Means and Senate Committee on Finance urged the Treasury to deal with the unsatisfactory problems associated with the regulations administratively. Treasury responded, but only on a temporary basis. The OBRA 1993 moratorium expired December 31, 1994, for calendar year taxpayers. Therefore, the 1977 regulations must now be applied for future years unless a regulatory or legislative solution is adopted.

As indicated above, Treas. Reg. 1.861-8(e)(3) works at cross purposes with the research credit. Although Treas. Reg. 1.861-8(e)(3) deals with the ability of companies to use the foreign tax credit to offset a portion of their U.S. income tax, the real economic effect of the regulations is to disallow any deduction for research and development expenses after a company is in an excess foreign tax credit position.

In 1983, CMA testified at length on this issue before the House Ways and Means Subcommittee on Oversight. (Hearings, Subcommittee on Oversight, House Committee on Ways and Means, 98th Congress, First Session, October 26; November 3, 1983). At that time we stated that the operation of the regulations would undermine the effectiveness of the research credit and would significantly increase the cost of that research in the United States. Moreover, we indicated that this increased cost of conducting research in the United States would be an important factor that would be considered in choosing whether to locate new research facilities here or abroad. We continue to believe that the regulations are ill-advised.

On at least seven occasions, Congress has wisely enacted and renewed the moratorium on apportionment of research and development expenses under the regulations. Unquestionably, a principal reason for doing so was the concern that the operation of the regulations was to encourage multinational businesses to shift research activities abroad. (See "Description of Proposals Relating to Research and Development Incentive Act of 1987 (S.58) and Allocation of R & D Expenses to U.S. and Foreign Income (S.716)", Joint Committee on Taxation, JCS-6-87, April 2, 1987.)

In 1989, National Science Foundation data suggested that U.S.-based corporations were increasingly conducting research outside the United States. R & D spending abroad by U.S.-based companies increased significantly more than comparable spending in the United States. Although the falling dollar accounted for some of this increase, R & D spending rose much faster abroad even after adjusting for depreciation of the dollar. The latest available National Science Foundation data demonstrate this trend is continuing. Based on 1992 data, a 1994 National Science Foundation study found that total company financed R & D performed outside the U.S. was $10.0 billion, equivalent to 10.3 percent of total company R & D spending. This represents an increase from the equivalent 8.5 percent share in 1987 and 7.7 percent in 1982. ("Selected Data on Research and Development In Industry: 1992," National Science Foundation, 1994.)

One reason for this trend is that the effects of the excess foreign tax credit limitation on research are far more widespread than previously assumed. It is estimated that, as a result of the corporate tax rate reductions in the 1986 Act, almost 70 percent of all corporations have an excess foreign tax credit limitations problem. As recognized by the staff of the Joint Committee on Taxation in 1987:

> "On the other hand, the rate reduction potentially modifies the conclusions reached in the Treasury study. The percentage of worldwide income of U.S. corporations earned by firms in an excess foreign tax credit position is expected to rise as a by-product of the rate reduction, with the result that any change in the R & D allocation rules can now be expected to have a more uniform effect, from firm to firm, than was true in 1983. Consequently, the rate reduction tends to make any future revision of the R & D allocation rules a relatively more efficient mechanism for influencing taxpayers' R & D decisions. This is because the mechanism works only on taxpayers

> with excess credits, and it works better to the extent that it causes a greater proportion of taxpayers to face similar incentives for undertaking R & D in the United States."
>
> JCS-6-87, pg. 42.

CMA believes that it is time to end the 18 years of controversy. The most rational solution is for Congress to enact a permanent allocation rule similar to the most recent moratorium.

We should also point out that the allocation required under Treas. Reg. 1.861-8 (e)(3) is also required to be used to compute the allowable export incentive under the Foreign Sales Corporation ("FSC"). The FSC provisions were enacted to enable U.S. exporters to be more competitive in world markets. When the regulations are applied in this context, allocating research and development expenses to export income has the effect of reducing FSC export incentive. CMA urges that any solution on the allocation of research and development expenses should also apply to the Foreign Sales Corporation provisions.

As CMA has emphasized, continued and expanded research and development in the United States is vital to our nation's economic future. Domestic tax policies that increase the cost of research in the United States while other nations continue to offer strong incentives to conduct research in their countries will provide continued motivation to reduce U.S. research activities, or to locate the research activities of U.S. firms outside the United States.

As a nation, America needs a strong private sector research establishment located in the United States. Through research we gain new technologies which are the source of continued economic growth and productivity, and provide the basis for new jobs and rising living standards.

Chairman JOHNSON. Thank you.
Mr. Sample.

STATEMENT OF BILL SAMPLE, DIRECTOR OF FINANCIAL SERVICES AND PRINCIPAL ACCOUNTING OFFICER, LOTUS DEVELOPMENT CORP., CAMBRIDGE, MASS., ON BEHALF OF R&D CREDIT/SECTION 861 COALITION

Mr. SAMPLE. Madam Chairman and distinguished members of the subcommittee, my name is Bill Sample. I am director of Financial Services for Lotus Development Corp. I am appearing today on behalf of the R&D Credit/Section 861 Coalition and Lotus. On behalf of the Coalition and Lotus, I would like to thank you for convening this hearing and providing Lotus and the Coalition the opportunity to testify.

The Coalition is comprised of several prominent trade associations and their many members, including several thousand companies with several million employees. The industries represented by the Coalition are among the most dynamic and fastest growing industries in the United States.

Lotus was incorporated in 1982 and is headquartered in Cambridge, Mass. Lotus employs over 6,000 people worldwide, including over 1,600 product development professionals and support staff.

Lotus' initial product, 1–2–3, was the most popular PC application software product in the world. In 1989 Lotus introduced Notes and defined a new category of PC software, workgroup computing.

Lotus competes in an industry where products have a technological life cycle of 18 to 24 months, and accordingly, Lotus invests heavily in product development activities. Since 1982 Lotus has reinvested approximately 14 percent of its revenues in R&D, with cumulative R&D spending exceeding $900 million.

The R&D credit was enacted in 1981, the year before Lotus was born. The funding provided by the credit has helped nurture Lotus through its infancy, childhood, and now into its teen years. Lotus is a $970 million success story built on innovative technology, and the R&D credit has played an important part in our success.

Lotus is also an international software company deriving approximately 50 percent of its revenue from overseas. The 861 R&D allocation rules have caused excess foreign tax credits and double taxation for Lotus, and we feel permanent improved allocation rules are an important component of encouraging exports and domestic R&D.

Madam Chairman, like the other members of our Coalition, intensive research and development efforts are vital to Lotus' ability to compete in the worldwide market. We strongly and wholeheartedly urge Congress to make the R&D credit permanent. Opponents of the credit have argued that the credit is not needed since R&D activities will be done with or without a credit. Madam Chairman, this is simply not true. High technology companies will always conduct R&D, but more projects exist than can be funded and promising ideas must often be cut from the list. The R&D credit provides an effective financial incentive for companies to engage in R&D projects on the margin, which might otherwise be canceled. These projects have and will continue to produce important technological advances and may save companies and jobs.

At Lotus we are constantly reminded of the benefits of investing in R&D projects outside of our core competency. In 1984 sales of Lotus 1–2–3 were growing beyond all expectations, and the company was one of the darlings of Wall Street. A young Lotus software engineer had an idea for a new software product, completely unrelated to Lotus' current business. Lotus senior management were hesitant to fund a project outside of their area of expertise, but eventually agreed to fund some development work. In the late eighties, spreadsheet revenue growth slowed and cost pressures caused the company to cut back on some R&D projects. The availability of the R&D credit to fund incremental R&D helped save this project.

This research project culminated in the development of Lotus Notes. Today, Notes is the unquestioned key to Lotus' success and survival, supporting over 6,000 jobs.

Madam Chairman, there have been ongoing discussions on the various ways the credit's current structure might be improved in order to enhance its effectiveness. While the subcommittee has clearly heard from companies proposing modifications to the credit's current structure, it is critical for the subcommittee to understand that many companies prefer the existing structure and would probably suffer a reduced credit if the current structure is changed. The current credit works well for Lotus and many other members of the Coalition. We do not believe that Congress should delay permanence while studying whether the credit ought to be revised. Accordingly, we believe making the credit permanent should be the first priority.

Current section 861 R&D rules, which can cause double taxation to foreign earnings, create a disincentive to perform R&D activities in the United States and increase the costs incurred by U.S. companies to compete in international markets. This disincentive works against the R&D credit's objective to increase U.S. R&D.

The existing Treasury regulations promulgated in 1977 reduce the extent to which foreign taxes can be credited against U.S. taxes, thereby increasing the overall effective tax rate. Recently, the Treasury Department has indicated that the 1977 rules are under review and revised regulations are imminent. We hope this will lead to a satisfactory, permanent regulatory solution which will eliminate the continuing controversy. However, if a satisfactory regulatory solution is not forthcoming, we ask the Ways and Means Committee to support a permanent legislative moratorium on the 1977 regulations and make permanent the so-called 64-percent solution, which has been previously enacted in response to this issue.

Madam Chairman, in closing, on behalf of the Coalition, I again thank you for inviting us to appear before you today, and I would like to introduce into the record an association letter to Secretary Rubin on the section 861 R&D allocation rules. Thank you.

[The prepared statement and letter follow:]

STATEMENT OF BILL SAMPLE
DIRECTOR OF FINANCIAL SERVICES AND PRINCIPAL ACCOUNTING OFFICER
LOTUS DEVELOPMENT CORP., CAMBRIDGE, MASS.
ON BEHALF OF R&D CREDIT/SECTION 861 COALITION

May 10, 1995

I. Introduction

Madame Chairman and distinguished members of the Subcommittee:

My name is Bill Sample. I am Director of Financial Services and Principal Accounting Officer of Lotus Development Corporation ("Lotus"). I am appearing today on behalf of the R&D Credit/Section 861 Coalition ("Coalition") and Lotus.

On behalf of the Coalition and Lotus, I would like to thank you for convening this hearing and for providing Lotus and the Coalition the opportunity to testify and participate in your Subcommittee's consideration of whether the research and experimentation tax credit, commonly known as the R&D Credit, should be made permanent and on formulating a permanent and fair solution to the Section 861 R&D allocation rules.

A. R&D Credit/Section 861 Coalition

I am also very proud to serve as Chairman of the R&D Credit Working Group of the R&D Credit/Section 861 Coalition and to be able to represent today the Coalition members. The Coalition is comprised of several prominent trade associations and their many members, including the American Electronics Association, the Biotechnology Industry Organization, the Business Software Alliance, the Electronic Industries Association, the Information Technology Association of America, the Pharmaceutical Research & Manufacturers of America, and the Software Publishers Association. These trade associations represent several thousand companies who employ several million U.S. workers. The industries represented by the Coalition are among the most dynamic and fastest growing industries in the United States. The members of these associations are closely following this issue and are very strong and active supporters both of a permanent R&D Credit and a satisfactory solution to the Section 861 R&D allocation rules.

B. Lotus Development Corporation

Lotus Development Corporation was incorporated in 1982 and is headquartered in Cambridge, Massachusetts. Lotus is engaged in the development, manufacture, sale and support of software products and services that meet the evolving technology and business applications requirements of individuals, workgroups, and entire organizations. Lotus employs over 6,000 people worldwide, including over 1,600 product development professionals and support staff.

Lotus' initial product, 1-2-3, was the most popular PC applications software product in the world, and is credited with helping to redefine business financial analysis techniques. In 1990, Lotus introduced Notes and defined a new category of PC software, workgroup computing. Notes is widely acclaimed for its ability to enable workgroups to access, track, share, route and organize information across diverse computing platforms and geographical boundaries. Notes is the preeminent client-server product for developing and deploying groupware applications, including those found in customer service, sales, account management, and product development. Notes workgroup capabilities improve the responsiveness and flexibility of product development organizations by enabling companies to decentralize their product development organizations to be closer to their markets.

Lotus competes in an industry where products have a technological life cycle of 18-24 months and accordingly Lotus invests heavily in product development activities. As our products become simpler to use, they are much more difficult to develop. For example, the

original version of 1-2-3 contained a little over 100,000 lines of code; later Windows versions contained over 500,000 code lines. Since 1982, Lotus has reinvested approximately 14% of its revenues in R&D, with cumulative R&D spending exceeding $900 million. Lotus' R&D investment is increasing, with over 16% of 1994 revenues invested in R&D and an even higher percentage planned for 1995.

The R&D credit was enacted in 1981, the year before Lotus was born. Lotus has taken full advantage of the R&D credit in each of the first 13 years of Lotus' existence, and the funding provided by the Credit has helped nurture Lotus through its infancy, childhood, and now into its teen years. Lotus is a $970 million success story built on innovative technology, and the R&D credit has played an important part in our success. Lotus is an international software company deriving approximately 50% of its revenue from overseas. The Section 861 R&D allocation rules have caused excess foreign tax credits and double taxation for Lotus and we feel permanent, improved allocation rules are an important component of encouraging exports and domestic R&D.

II. Importance of a Permanent R&D Credit

Madame Chairman, like the other members of our Coalition, intensive research and development efforts are vital to Lotus' ability to compete in the worldwide market. We strongly and whole-heartedly urge Congress to make the R&D Credit permanent.

Since its inception, the R&D Credit has provided a valuable economic incentive for U.S. companies to increase their investment in research and development in order to maintain their competitive edge in the global marketplace. The software industry has invested heavily in R&D and the U.S. software industry currently maintains a majority market share in each of the world's major economies. A permanent R&D Credit is critical to fast-growing R&D intensive companies such as those in the software industry and the many other industries represented by the Coalition.

A permanent R&D Credit is also important to encourage U.S. industry to continue R&D activities in the U.S. rather than moving such activities offshore. Most of the major industrialized European and Asian countries (including the United Kingdom, France, Germany, Japanese and others), as well as Canada, offer various R&D-related tax and financial incentives to assist native companies and to encourage foreign companies to locate R&D projects within their borders. These incentives lower the cost of R&D in these foreign jurisdictions and provide foreign companies competitive advantages over U.S. industries absent similar U.S. R&D incentives. Foreign incentives have encouraged Lotus and other U.S. companies to locate some product development offshore, especially R&D targeted towards developing products for foreign markets. Communications products like Lotus Notes are making it easier to decentralize R&D activities. The U.S. must continue to offer R&D incentives to compete for such R&D projects.

III. Effectiveness of R&D Credit

The R&D Credit has been effective in achieving the goals for which it was originally enacted. A key finding of the 1994 study by Rudy Penner on behalf of the KPMG Peat Marwick Policy Economic Group entitled "Extending the R&E Tax Credit; The Importance of Permanence" is that the marginal effect of one dollar of the R&D Credit has been to stimulate one dollar of additional private R&D spending in the short-run and as much as two dollars of additional R&D spending in the long-run.[1/]

Opponents of the Credit have argued that the Credit is not needed since R&D activities will be done with or without a credit. Madame Chairman, this is simply not true for the software industry and the research-intensive industries represented by the Coalition. Although

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[1/] A copy of this 1994 study is submitted herewith for the record.

high technology companies will always conduct R&D, more projects exist than can be funded and promising ideas must often be cut from the list. The R&D Credit provides an effective financial incentive for companies to engage in R&D projects on the margin which, because of fiscal and other restraints, might otherwise be canceled. These projects have, and will continue to produce important technological advances and may save companies and jobs.

At Lotus, we are constantly reminded of the benefits of investing in marginal R&D projects outside of our core competency. In 1984, sales of Lotus 1-2-3 were growing beyond all expectations and the Company was one of the darlings of Wall Street. A young Lotus software engineer had an idea for a new software product completely unrelated to Lotus' current business. Lotus senior management, satisfied with their spreadsheet success, were hesitant to fund a project outside of their area of expertise, but eventually agreed to fund some development work if the engineer agreed to perform the R&D in a separate company so as not to interfere with Lotus' existing business. In the late 1980's, spreadsheet revenue growth slowed and cost pressures caused the Company to cut back on some R&D projects. Lotus' Vice President of Finance, who believed in the young engineer's product vision, used the availability of the R&D credit to fund incremental R&D to help save this project. This research project culminated in the development of Lotus Notes which first went on the market in 1989. Today, Notes is the unquestioned key to Lotus' continued success and survival, supporting over 6,000 jobs.

IV. Lack of Permanence Reduces Effectiveness of R&D Credit

Unfortunately, the incentive benefit of the current R&D Credit has been reduced because of its temporary and uncertain nature. In industry today, many product development initiatives and research projects have long lead times - often up to twelve years - and corporate decision makers are hesitant to factor in the Credit's benefits due to the uncertainty over the long-term availability of the Credit.

History has shown their hesitancy is well-founded. While the Credit has been renewed six (6) times since 1981, in one instance the Credit was renewed for only six months and on two occasions, the R&D Credit was actually allowed to expire only to be renewed retroactively. Further, adding to the frustration of American industry has been the fact that each time the Credit has been extended, its supporters have had to find revenue offsets to "pay for" the Credit which have become a permanent part of the Tax Code while the Credit remains only temporary. Supporters of the Credit feel they have had to "pay for" the Credit time and time again. This pattern of short-term extensions and lapses in the Credit followed by periods of uncertainty, reduces our ability to factor the R&D Credit into planning for long-term projects and reduces the incentive value and effectiveness of the R&D Credit.

V. R&D Credit Should Be Made Permanent

As our companies and markets mature, and competition increases, management faces the same dilemma over and over again. It must fund research, which like all research efforts is high-risk, over a long period of time while showing a profit to satisfy equity investors. Lotus, although it is only 13 years old and still undergoing major product transitions, is expected to produce significant profits. This requires management to reduce non-research costs, as well as make difficult and painful decisions on which research projects to fund and which to abandon. Given the lean budgets companies must maintain in order to remain competitive, R&D projects frequently are the swing items in the budget. Thus, management is constantly faced with the dilemma of whether it must drop some of its promising but higher risk R&D projects in order to meet financial targets. The R&D Credit is critical to companies and their long-term R&D projects and can make the difference in whether a particular project is retained or abandoned. In fact, this is precisely the result Congress intended when it first enacted the R&D credit - namely that the Credit would provide the additional incentive to encourage real increases in R&D.

Madame Chairman, that is why we need permanence. The R&D Credit can most effectively incentivize R&D projects if decisionmakers know the Credit will be there for the long run.

VI. Background on R&D Credit - A Good Investment

The R&D Credit was originally enacted in 1981 to provide an incentive for companies to increase existing levels of R&D in the United States. The Credit was designed to encourage industry to increase U.S.-based R&D and applies only to increases in domestic R&D above a specified base amount.

Under the current credit, taxpayers are eligible to receive a credit equal to 20% of Qualified Research Expenditures or "QREs", in excess of a specified base amount. The current year base amount is calculated by applying a historical R&D spending-to-revenue ratio (using 1984-1988 amounts) to the taxpayer's average revenues for the preceding four years. However, the base amount can never be less than 50% of current year QRE's, which will reduce the Credit's marginal rate to 10%. This effective rate is further reduced to 6.5% because corporations must reduce their tax deduction for R&D expenses by an amount equal to the credit. These rules effectively leverage the Credit such that a U.S. taxpayer must spend $100 on QREs to receive $6.50 of R&D tax credit. Conversely, the U.S. government is assured that every $1 of R&D credit given has generated over $16 of private sector QRE spending.

QREs are limited to domestic spending and consist primarily of salaries and wages paid for direct research, supervision and support of R&D, 65% of payments to outside contractors for R&D, certain R&D supplies, computer time sharing directly related to R&D activities, and basic research payments to universities. The Credit does not apply to indirect expenditures, R&D expenditures supporting R&D activities such as R&D facilities, overhead (or depreciation), computers, equipment, infrastructure, executive compensation or most employee fringe benefits. In fact, roughly one-half of a company's financial statement R&D does not qualify for the Credit thereby further limiting its effective rate and increasing its spending leverage. Hence, the Credit's narrow base limits abuse and applies only to direct, legitimate R&D efforts. Moreover, since the conduct of R&D is a labor intensive activity, the single biggest component of the credit base historically has been wages and salaries. These wages and salaries tend to be for engineers, scientists, researchers and their direct assistants, which generally comprise "middle-class" jobs, a critical sector of job growth in our economy. Further, certain developmental efforts such as those by pharmaceutical companies are often conducted at university hospitals, thereby assisting the university systems.

In short, the Credit allows the private sector (rather than the government) to determine where R&D dollars are most efficiently allocated, rewards incremental R&D domestic spending, is highly leveraged, encourages middle-class job growth, and enhances the ability of U.S. companies to compete in the global marketplace.

VII. Consideration of Structural Changes to R&D Credit

Madame Chairman, as you know, there have been ongoing discussions on the various ways the Credit's current structure might be improved in order to enhance its effectiveness, such as having a rolling base period, making the Credit a flat rate with no reference to a base period, reducing the maximum fixed base percentage limitation below 16%, and eliminating the 50% minimum base rule. Alternatively, some have suggested that the current structure be retained but that taxpayers be given a right to elect at specific times to change to alternate rules. While the Committee has clearly heard from companies proposing modifications to the Credit's current structure, it is critical for the Committee to understand that many companies prefer the existing structure and would probably suffer a reduced credit if the current structure is changed. One of the reasons for adopting the 1989 changes creating a fixed base percentage, and calculating the base period amount by reference to revenue, was to correct a

flaw in the original Credit's base period computation which caused companies to spend their way out of the Credit. Under the original three-year rolling average spending base amount computation, increased R&D spending also increased the base amount, making the Credit more difficult to obtain in future years. Since the purpose of the R&D Credit is to encourage increases in R&D spending, the base period mechanics should not penalize companies for increasing R&D spending. The 1989 changes generally corrected this problem. The current Credit works well for Lotus and many other members of the Coalition. This important feature of the current Credit should be retained.

Many options exist as to the various changes that could be made to the credit; however, there is no consensus at this time as to which, if any, would be beneficial to the business community. The Committee would find general support for reversing the various limitations imposed on the original Credit during the 1980's, such as the reduction in the credit rate from 25% to 20% and the loss of the deduction for Section 174 expenses. Changing the Credit mechanics within a fixed revenue limitation, however, will be a difficult process creating winners and losers which deserves careful consideration and study.

We do not believe that Congress should delay permanence while studying whether the Credit ought to be revised. Accordingly, we believe making the Credit permanent should be the first priority.

VIII. Section 861 R&D Allocation Rule

The current Section 861 R&D allocation rules, which can cause double taxation of foreign earnings, create a disincentive to perform R&D activities in the U.S. and increase the costs incurred by U.S. companies to compete in international markets. We strongly believe the current regulatory rules adversely affects U.S. R&D and the R&D Credit; the rules discourage the same U.S. R&D the R&D Credit is intended to encourage.

The Section 861 R&D allocation issue relates primarily to the allocation of U.S.-based research expense for purposes of computing a U.S. company's foreign tax credit. The issue spans an 18-year period of continuing controversy, focused on Treasury Regulation section 1.861-8(e)(3). Under this regulation, issued in 1977, U.S.-owned, research-intensive companies with foreign operations are required to treat a significant portion of their U.S. research expenditures "as if" such research was conducted offshore for purposes of determining foreign tax credits. This reduces the extent to which foreign taxes can be credited against U.S. taxes thereby increasing the overall effective rate of tax (U.S. and foreign) to which such companies are subject and possibly causing double taxation of foreign source income. These allocation rules are arbitrary and create a bias against U.S.-based research and U.S.-owned companies competing in a global environment. In my experience, no foreign country allows a tax deduction for this research which has, in fact, been conducted in the U.S. Consequently, these U.S. companies effectively and economically lose a deduction for the expenditures and are exposed to international double taxation to the extent they have excess foreign tax credits. In effect, a penalty is directed at those American companies performing substantial U.S. R&D and successfully competing in global markets; both of these characteristics are highly beneficial to the U.S. economy and crucial to the growth of the high-tech companies in the Coalition. As a multinational company competing in a variety of foreign markets, Lotus, as are many other Coalition members, is adversely affected by the existing R&D expense allocation rules.

Based on the existing regulation, the only way to ensure that such expenses receive full deductibility would be to perform the research in a foreign country rather than in the U.S. Recognizing that this is counterproductive to American economic interests, and works against the primary objective of the R&D tax credit - to increase U.S. R&D, Congress has periodically imposed a complete or partial moratorium on the 1977 regulatory rules. The most recent moratorium expired December 31, 1994 for calendar year taxpayers, so it is important that this problem be corrected as soon as possible.

In addition to being an incentive for the expatriation of U.S.-based R&D, the Section 861 rules impose a competitive disadvantage on those U.S.-owned companies subject to the rules. Consider for a moment two multi-national companies, one U.S.-owned and one foreign-owned, and both investing in new R&D. To focus on the effects of 861, assume that the two companies have identical U.S. operations -- same investment, cost structure, products, technology, management, workforce, and the same level of U.S.-based R&D. The U.S.-owned company would be subject to a higher tax burden than the foreign-owned U.S. operation due to Section 861 and hence would be at a serious competitive disadvantage relative to the foreign-owned competitor -- a disadvantage which would grow each year solely as a result of the Section 861 R&D allocation provisions. Further, to the extent the foreign-owned competitor conducts its research outside the U.S., it would again enjoy full deductibility in its home country. In short, these U.S. tax rules impose a competitive disadvantage against many U.S.-owned companies.

I believe we would all agree that U.S. tax rules should not put U.S.-owned companies at a competitive disadvantage for locating R&D in the U.S. This requires a permanent and better solution to the issue of the allocation of U.S.-based research expenses.

Recently, the Treasury Department has indicated that the 1977 rules in question are under review. We hope this will lead to a satisfactory permanent regulatory solution which will eliminate the continuing controversy. Treasury certainly has the authority to resolve these issues, and we hope the Ways and Means Committee and the Congress will urge Treasury to exercise its authority. However, if a regulatory solution is not forthcoming, we ask the Ways and Means Committee to support a permanent legislative moratorium on the 1977 regulations and make permanent the so-called "64% percent solution" which has been previously enacted in response to this issue.

IX. Conclusion

Madame Chairman, in closing, I again thank you for inviting me to appear before you today. I and the many other members of the R&D Credit/Section 861 Coalition look forward to working with you and the other members of the Subcommittee in achieving permanence for the R&D Credit and in finding a satisfactory permanent solution for the R&D expense allocation rules.

R&D CREDIT/SECTION 861 COALITION

September 6, 1995

Commissioner Margaret Richardson
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Attn: CC:DOM:CORP:T:R (INTL-0023-95)

Re: *Proposed Regulation § 1.861-8(e)(3)*

Dear Commissioner Richardson:

We, the R&D Credit/Section 861 Coalition, are writing in response to the Notice of Proposed Rulemaking published in the Federal Register on May 24, 1995 (60 Fed. Reg. 27453) regarding the proposed regulations concerning the allocation and apportionment of research and experimental ("R&D") expenditures for purposes of determining taxable income from sources within and without the United States (hereinafter referred to as the "Proposed Regulations").

The Coalition is comprised of several prominent trade associations including the American Electronics Association, Chemical Manufacturers Association, Electronic Industries Association, Information Technology Industry Council, National Association of Manufacturers, Pharmaceutical Research & Manufacturers of America, Software Publishers Association and the U.S. Chamber of Commerce.

The Coalition applauds Treasury's efforts in reexamining the proper allocation and apportionment of deductions for U.S.-based R&D expenditures to foreign income and, specifically, Treas. Reg. § 1.861-8(e) (the "1977 Regulations"). For over 17 years, there has been uncertainty regarding the proper allocation and apportionment of deductions for U.S.-based R&D expenditures to foreign income. It is time for a permanent resolution, and the Coalition believes that the Proposed Regulations represent a significant step in the right direction.

In addition to being pleased with the attempt to permanently resolve this issue, the Coalition is also pleased with a number of technical decisions underlying the

Proposed Regulations. First, the Coalition agrees with the decision to adopt the three digit (rather than two digit) SIC code grouping rule. The three digit grouping rule allows taxpayers to avoid allocating U.S. research to foreign income that is truly unrelated to that U.S. research.

Second, the Coalition applauds the decision not to adopt the so-called "goose-to-gander" provision included in Section 864(f) of the Internal Revenue Code (the "Code") because that provision had failed to recognize the greater impact of parent country affiliation on commercialization of R&D. The rule in the Proposed Regulation, therefore, achieves a more proper matching of income and expense.

Finally, the Coalition is pleased with Treasury's decision to conform the treatment of the Section 936 and R&D allocation rules to the former Section 864(f) rules. Those rules provided that the R&D expenditures taken into account under the allocation rules should be reduced by amounts taken into account under either the cost sharing or profit split method as computed under Section 936(h) (5) (C). Nonetheless, the Coalition believes that to fully affect this result, the language of the Proposed Regulations should be modified to explicitly clarify that the reduction in R&E expenditures provided by Prop. Reg. § 1.861-8(e) (3) (i) (C) (3) applies when the taxpayer has elected either the cost sharing or the profit split method under Section 936 (h) (5) (C).

Although the Coalition generally subscribes to the approach taken in the Proposed Regulations and believes they are a substantial improvement over the 1977 Regulations, the Coalition believes that the Proposed Regulations can be improved in the following ways.

First, in light of the historical response to the 1977 Regulations, the exclusive apportionment provision applicable to the gross sales method of apportionment should be expanded to include the optional gross income method of apportionment. Second, the election of the optional gross income method of apportionment should not be binding on a taxpayer for subsequent years but, rather, should be available on a year-by-year basis. Finally, the effective date of the Proposed Regulations should be modified to cover fiscal year taxpayers whose taxable years begin after August 1, 1994 but before January 1, 1995. Each of these recommendations are discussed below.

Extension of Exclusive Apportionment to Optional Gross Income Method

The 1977 Regulations provide that in lieu of apportioning the deduction for R&D expenditures on the basis of gross sales, taxpayers may annually elect to apportion the entire deduction on the basis of gross income. The 1977 Regulations, however, do not permit taxpayers to apportion R&D expenditures exclusively to the place of performance if they elect to use the optional gross income method. The Proposed Regulations continue this approach, notwithstanding that Treasury concluded in its own related Study that, in order to increase the fairness of the 1977 Regulations, the Proposed Regulations should reduce the allocation of domestic R&D to foreign income by 25 percent in comparison to the 1977 Regulations. For taxpayers that consistently use the gross income method, the Proposed Regulations do not provide any material relief from the 1977 Regulations. The Proposed Regulations, therefore, fail to fulfill Treasury's own goal.

In order for taxpayers to avoid the potential of double taxation, allocations of R&D expenditures would have to be based solely on each taxpayer's facts and circumstances. The 1977 Regulations acknowledged that due to differences in facts and circumstances, some taxpayers could reduce their exposure to double taxation by use of the gross sales method and others through use of the gross income method. For the Treasury to allow those taxpayers who utilize the gross sales method to reduce the risk of double taxation by 25 percent as compared to the 1977 Regulations but not allow those who utilize the gross income method to reduce their risk by a comparable amount, is patently unfair. The Proposed Regulations have broken the equilibrium of the past 14 years between those taxpayers who use the gross sales method and those who use the gross income method. This equilibrium should be retained by permitting those taxpayers who use the gross income method to exclusively apportion their R&D expenditures on the same basis as taxpayers who use the gross sales method of apportionment.

The Internal Revenue Service should treat the two methods consistently, especially since it treated the methods consistently in Rev. Proc. 92-56 and the Administration expressed support for a revenue-neutral extension of Section 864(f) of the Code which provides for Tax Proposals Before the House Committee on Ways and Means, 104th Cong., 1st Sess.42 (statement of Leslie B. Samuels, Asst. Secretary (Tax

Policy, Dept. of the Treasury). Thus, the Coalition notes that the Treasury has publicly supported consistent treatment of the gross sales and gross income methods.

The Optional Gross Income Method Should Not Be Binding

As noted above, the 1977 Regulations acknowledged that due to differences in facts and circumstances, some taxpayers could reduce their exposure to double taxation by use of the gross sales method and others through use of the gross income method. The requirement in the Proposed Regulations that taxpayers who elect to apportion R&D expenditures on the optional gross income method are bound to use such method in future taxable years nonetheless, ignores such factual differences. Neither the Proposed Regulations nor the Treasury Study gives any indication why the binding election rule was adopted. Regardless of the level of exclusive apportionment ultimately provided by the regulations for the gross income method, it is nevertheless an acceptable method, and as such, should not be burdened by extra requirements not placed on the other acceptable method. Taxpayers should be entitled to choose each year the method of apportionment that best reduces their potential for double taxation. There is no tax advantage to taxpayers who elect to apportion R&D expenditures on the basis of gross income in one year and then on the basis of gross sales the next; such taxpayers are merely reducing the real cost of double taxation.

Modification of Effective Date Provision

The effective date of the Proposed Regulations is for taxable years beginning after December 31, 1995, although the regulation gives taxpayers the option of electing to apply the Regulations for taxable years beginning after December 31, 1994. This effective date permits calendar year companies to apply the new regulation to their first taxable year beginning after the regulation's latest moratorium. Fiscal year companies whose taxable years begin after August 1, 1994, but before January 1, 1995, however, will suffer a one year "gap" during which the 1977 Regulations will apply because the last extension of the moratorium on the 1977 Regulations applied to the first taxable year beginning on or before August 1, 1994. Section 864(f)(6) of the Code, as amended by the OBRA OF 1993.

Although the gap in the effective date provisions of Section 864(f)(6) of the Code and the Proposed Regulations may only be an oversight, it needs to be corrected in order to prevent unfair results to fiscal year taxpayers whose taxable years began after August 1, 1994, but before January 1, 1995.

Thank you for considering these comments.

Sincerely,

American Electronics Association
Chemical Manufacturers Association
Electronic Industries Association
Information Technology Industry Council
National Association of Manufacturers
Pharmaceutical Research & Manufacturers of America
Software Publishers Association
U.S. Chamber of Commerce

Chairman JOHNSON. Thank you very much, Mr. Sample.
Ms. Kaye.

STATEMENT OF TRACY ANNE KAYE, ASSOCIATE PROFESSOR OF LAW, SETON HALL UNIVERSITY SCHOOL OF LAW, SETON HALL UNIVERSITY, NEWARK, N.J.

Ms. KAYE. Thank you, Madam Chairman, and members of the Subcommittee on Oversight, for the opportunity to testify before you today. I am Tracy Kaye, an associate professor of law at Seton Hall University School of Law. I appear before you today to comment on the 861 R&D allocation rules.

I am here to urge Congress to take into consideration international economic policy and the effects of any proposals on the competitiveness of U.S. corporations. U.S. international tax policy needs to minimize tax deterrents to productive international economic activities and needs to avoid creating a hostile tax environment.

The reality of the global marketplace is that our tax system must interact with other countries' tax systems. Therefore, Congress should consider other nations' tax systems when designing our own. The United States uses a foreign tax credit system to eliminate international double taxation. This credit is limited, however, to the U.S. tax liability on foreign-source taxable income. To compute this limitation, sourcing of income and allocation of expense rules are necessary to determine foreign-source taxable income.

These rules generally aim to ensure that income subjected to foreign tax is treated as foreign source. Any allocation of expense to foreign-source gross income reduces foreign-source taxable income and, correspondingly, the foreign tax credit limitation. Thus, too great an allocation to foreign-source income leads to double taxation.

The R&D expense category has proven to be one of the most difficult to allocate, primarily because R&D expenses are capital in nature. Although these costs are incurred to earn future income, code section 174 permits a current deduction.

Most expenses are allocated to domestic or foreign-source income on the basis of their factual relationship to the production of particular gross income. Because R&D expenses do not generally relate to gross income earned in the current period, the matching principle is not helpful.

The regulations contain detailed rules for the allocation and apportionment of R&D expenses. Since 1981, the regulation has been modified eight times by legislation, which lets you know there is a problem. What is this problem? Well, conflicts between the sourcing of income and allocation of expense rules of the United States and foreign countries lead to economic double taxation. No foreign country grants a deduction for R&D performed in the United States just because a U.S. regulation allocates that expense to foreign-source income.

What do other countries do? Many countries use a tracing approach, allocating expenses incurred within the residence country to domestic-source income, and expenses incurred outside the country to foreign-source income.

Other countries follow generally accepted accounting principles for attributing items of expense to categories of gross income. To my knowledge, no country has R&D allocation rules similar to the U.S. rules. Generally, the allocation of expense rules of foreign countries are much less developed and often relying on a facts-and-circumstances determination. This absence of sophisticated 861 allocations in foreign countries means that foreign-owned multinationals enjoy a tax advantage over the foreign activities of U.S. multinationals.

The sourcing of income and expense allocation rules should be designed to achieve three goals—the elimination of double taxation, the elimination of undertaxation, and the distribution of tax jurisdiction among sovereign governments in some mutually agreeable fashion. The only solution that will simultaneously satisfy all three goals is international consensus on a set of rules for the sourcing of income and the allocation of expenses. Therefore, I urge Congress to encourage the Treasury Department to take the lead in the negotiation of such a harmonized set of rules.

Until such an international agreement is reached, however, I propose that the allocation of R&D expense to foreign-source income should only occur where deductible in the foreign jurisdiction.

The tax planning of multinationals focuses on the reduction of worldwide tax liability, not just U.S. tax liability. Therefore, given that U.S. corporate tax rates are often lower than most other jurisdictions, there is already a built-in incentive to claim all allowable deductions against foreign-source income aggressively so as to reduce the foreign tax burden. To the extent U.S. multinationals are operating in jurisdictions with lower tax rates than the United States, it will be necessary to develop a mechanism to allocate the R&D expense allowable as a deduction in the foreign jurisdiction.

I believe this departure from U.S. tax policy is justified because of the unique income measurement problems that exist with respect to R&D expenses. The U.S. unilateral resolution to this issue has led to double taxation for many U.S. multinationals. This is admittedly a second-best and should not be a permanent solution.

Once again, the only way to satisfy the international goals of designing a system that avoids overtaxation and undertaxation is to harmonize the rules for the sourcing of income and the allocation of expenses.

Thank you.

[The prepared statement follows:]

Testimony of

TRACY ANNE KAYE
Associate Professor of Law
Seton Hall University School of Law

Before the

COMMITTEE ON WAYS AND MEANS
SUBCOMMITTEE ON OVERSIGHT
UNITED STATES HOUSE OF REPRESENTATIVES

May 10, 1995

Introduction

Thank you, Chairman Johnson, Congressman Matsui, and Members of the Subcommittee on Oversight, for the opportunity to testify before you today. I am Tracy Kaye, an Associate Professor of Law at Seton Hall University School of Law. I appear before you today to comment on Treasury Regulation Section 1.861-8(e)(3), the research and experimentation expense allocation rules, often referred to as the "861 R&D allocation rules."

I am here to urge Congress to take into consideration international economic policy and the effects of any proposals on the competitiveness of U.S. corporations. U.S. international tax policy needs to minimize tax deterrents to productive international economic activities and avoid creating a hostile tax environment.

Applying the United States income tax system to international transactions is inherently complex because cross-border transactions do not have a single geographic source. Thus, in order to avoid either double taxation or undertaxation of these transactions, a coherent set of rules for determining the geographical source of taxable income must be developed. To achieve a coherent system of international taxation, the United States should take note of how other countries tax international income.[1] The reality of the global marketplace is that our tax system must interact with other countries' tax systems. Therefore, Congress should consider other nations' tax systems in designing our own.

Historical Background

The United States taxes the worldwide income of its corporations and uses a foreign tax credit system to eliminate international double taxation. The foreign tax credit is limited to the United States tax liability on foreign source taxable income to ensure that the foreign tax credit does not reduce the U.S. corporation's taxes on its domestic income. To compute this limitation, sourcing of income and allocation of expense rules are necessary to determine foreign source taxable income. The rules generally aim to ensure that income subjected to foreign tax is treated as foreign source. Any allocation of expense to foreign source gross income reduces foreign source taxable income and correspondingly the foreign tax credit limitation. Thus, too great an allocation to foreign source income leads to double taxation; too little leads to undertaxation of the cross-border income.[2]

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[1]Charles I. Kingson, The Coherence of International Taxation, 81 Colum. L. Rev. 1151, 1153 (1981).

[2]Department of the Treasury; International Tax Reform, An Interim Report (January 1993).

The research and development (R&D) expense category has proven to be one of the most difficult to allocate, primarily because R&D expenses are capital in nature. Although these costs are incurred to earn future income, code section 174 permits a current deduction as an incentive for the performance of R&D. Most expenses are allocated to domestic or foreign source income on the basis of their factual relationship to the production of particular gross income. Because R&D deductions do not generally relate to gross income earned in the current period, the matching principle of Treasury regulation 1.861-8 is not helpful.

The Section 1.861-8 regulations, published in 1977, contain detailed rules for the allocation and apportionment of R&D expenses. These rules require government mandated R&D expenses to be allocated to the gross income arising in the country where the benefit is expected to be derived. The remaining R&D expenses must be allocated to the product categories to which they relate or to all categories if the expenses cannot be related to a particular product category.[3] Allocation is followed by an apportionment procedure whereby a fixed percentage of R&D (at present 30 percent) is apportioned to the geographic source where over half of the taxpayer's deductible research expenses are incurred.[4] The remaining expense is apportioned on the basis of gross sales.[5]

Alternatively, a taxpayer may use an optional gross income method to apportion the non-government mandated expenses on the basis of relative amounts of gross income from domestic and foreign sources.[6] Unfortunately, it is actually even more complicated than the above description. Since 1981, this regulation has been modified eight times by temporary legislation to permit an exclusive apportionment (ranging from 50 percent to 100 percent) to the actual place of performance of the R&D.

Problem

Conflicts between the sourcing of income and allocation of expense rules of the United States and foreign countries lead to economic double taxation. No foreign country grants a deduction for R&D performed in the U.S. on the basis of U.S. regulatory allocation of that expense to foreign source income. Many countries use a tracing approach, allocating expenses incurred within the residence country to domestic source income and expenses incurred outside the country to foreign source income. Other countries follow generally accepted accounting principles for attributing items of expense to categories of gross income.[7]

To my knowledge, no country has R&D allocation rules similar to those required by the United States. Generally, the allocation of expense rules of foreign countries are much less developed, often relying on a facts and circumstances determination.[8] This absence of sophisticated 861 allocations in foreign countries means that foreign-owned multinationals enjoy a tax advantage over the foreign activities of U.S. multinationals.[9]

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[3]Treasury Regulation Section 1.861-8(e)(3)(i)(A).

[4]Treasury Regulation Section 1.861-8(e)(3)(ii)(A).

[5]Treasury Regulation Section 1.861-8(e)(3)(ii)(B).

[6]Treasury Regulation Section 1.861-8(e)(3)(iii).

[7]Department of the Treasury, *supra* note 2 at 31.

[8]International Fiscal Association (IFA), *Rules for determining income and expenses as domestic or foreign*, LXVb Cahiers de droit fiscal international (1980).

[9]Charles I. Kingson, *The Foreign Tax Credit and Its Critics*, 9 Am. J. of Tax Policy 1, 57 (1991).

Recommendation

The sourcing of income and expense allocation rules should be designed to achieve three goals: 1) the elimination of double taxation; 2) the elimination of undertaxation; and 3) the distribution of tax jurisdiction over taxable income among sovereign governments in some mutually agreeable fashion.[10] The only solution that will simultaneously satisfy all three goals is international consensus on a set of rules for the sourcing of income and the allocation of expenses. Therefore, I urge Congress to encourage the Treasury Department to take the lead in the negotiation of such a harmonized set of rules.

Until such an international agreement is reached, I propose that the allocation of R&D expense to foreign source income should only occur where deductible in the foreign jurisdiction. The tax planning of multinationals focuses on the reduction of worldwide tax liability, not just U.S. tax liability. Therefore, given that U.S. corporate tax rates are often lower than most other jurisdictions,[11] there is already a built-in incentive to claim all allowable deductions against foreign source income aggressively so as to reduce the foreign tax burden. To the extent U.S. multinationals are operating in jurisdictions with a lower tax rate than that of the U.S., it will be necessary to develop a mechanism to allocate the greatest amount of R&D expense allowable as a deduction in the foreign jurisdiction.

This is a departure from traditional U.S. tax policy which requires that foreign source taxable income be computed according to U.S. concepts. It is probable that research expenses incurred in the U.S. produce not only domestic income but also foreign income,[12] therefore to the extent the amount of research expense deductible in the foreign jurisdiction is less than the amount properly allocable to the foreign source income, the United States would suffer a loss of revenue in favor of the foreign jurisdiction.

I believe this departure from U.S. tax policy is justified because of the unique income measurement problems that exist with respect to R&D expenses. The United States' unilateral resolution to this issue has led to double taxation for many U.S. multinationals.[13] In theory, these double taxation problems should be resolved through the negotiation of bilateral treaties and the competent authority mechanism.[14] However, given the limited treaty network of the United States, the lengthy treaty negotiation process, and the problems with the competent authority process, this is not realistic.

This is admittedly a second best, and should not be a permanent, solution. Once again, the only way to satisfy the international goals of designing a system that avoids overtaxation and undertaxation as well as providing for an equitable distribution of tax revenue among sovereign governments is to harmonize the rules for the sourcing of income and the allocation of expenses. It will be necessary to study the approaches taken by the various governments' tax systems and develop a system that is mutually agreeable. Note that these rules are of paramount importance whether administrating a territorial tax system or a foreign tax credit system.

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[10]Michael J. McIntyre, *The International Income Tax Rules of the United States*, 3-65 (Butterworth 1992).

[11]See Ernst & Young, *Worldwide Corporate Tax Guide* (1994).

[12]The counterargument made by some is that these expenses are recovered initially in the domestic market, and, as royalties or other payments represent the profits, no allocation should be made to foreign income.

[13]Double taxation only occurs for those taxpayers in an excess foreign tax credit position, i.e. those taxpayers whose foreign income taxes paid exceed their foreign tax credit limitation. It is generally assumed that the majority of multinational corporations are in an excess credit position.

[14]McIntyre, *supra* note 10.

As cross-border activity between Canada and Mexico increases because of the North American Free Trade Agreement, it will be necessary to attempt some harmonization of these respective tax systems, including the allocation of R&D expenses. The European Union, now comprised of fifteen countries, is already engaged in a similar exercise.[15] These efforts should pave the way for the negotiation of a coherent system for the sourcing of income and allocation of expenses of international transactions.

[15]See generally, Tracy Kaye, *European Community Tax Harmonization and the Implications for U.S. Tax Policy*, Tax Foundation (1994).

Chairman JOHNSON. Thank you very much, Ms. Kaye.
Mr. Wiacek.

STATEMENT OF RAYMOND J. WIACEK, TAX COUNSEL, JONES, DAY, REAVIS & POGUE, ON BEHALF OF EMERGENCY COMMITTEE FOR AMERICAN TRADE

Mr. WIACEK. Thank you, Madam Chair. My name is Ray Wiacek. I am here to testify on behalf of the ECAT, Emergency Committee for American Trade.

ECAT is an organization of about 60 very large U.S. multinationals. They employ over 5 million people and generate annual sales in excess of $1 trillion. The membership includes some of the most R&D-intensive companies in the world.

I am here to talk about the so-called 861 R&D regulations, and I have submitted a written statement for the record, so I would like to come off the written page and just talk to you directly and briefly for a moment.

The 861 R&D regulations treat a portion of U.S.-performed R&D as if it were done abroad. Technically, these rules work through the foreign tax credit rules. But there are economic consequences, principally the denial of a deduction for that portion of U.S. R&D deemed to be foreign.

Now, as Professor Kaye has said, no foreign country grants a deduction for such R&D. From time to time, the Joint Committee has pointed out that this might be wrong as a purely theoretical matter. I think in the Joint Committee's pamphlet for the last hearings on this apportionment issue they cited the Philippines and Turkey as possibilities where you might get a deduction. In the Joint Committee's pamphlet for this hearing, it is noted that in Finland or New Zealand a U.S. company also might be able to obtain a deduction. The Joint Committee specifically notes, however, that in such major trading partners as Japan and Canada, that no deduction would be obtained.

Of course, in the real world the denial of such a deduction makes sense. You would know yourself, Madam Chair, that there is not a chance that we would get a deduction in Japan for engineering salaries paid or lab supplies purchased in Connecticut. It just isn't going to happen.

Now, the consequence of the section 861 R&D apportionment regulations is that the cost of U.S. R&D has been increased, or put another way, that the amount of R&D that you could do for a given level of investment is decreased.

These section 861 R&D regulations are about as controversial as any I can remember. They were first issued in 1977. They phased in and became fully operational in 1980, and almost immediately Congress began to enact a series of full and partial moratoriums—moratorium against their application. Looking back at this activity, it is like reviewing a "who's who" list of the tax legislation of the last dozen years.

Congress first enacted a moratorium in 1981 in ERTA, then again in DEFRA, then again in COBRA, then again in the 1986 Tax Reform Act, then in all the various OBRAs of the late eighties and the Tax Extension Act and so on. I think Mr. Sinaikin said he thought there were seven. By my count, there have been nine legis-

lative moratoriums. The Treasury also acted in 1992 administratively, granting relief from its own regulations.

Now, a lot of good has come from the above activity. For one thing, the record is long. All of this activity has been accompanied by testimony, studies, committee reports, that time and again question the tax policy, noting the disincentive to U.S. R&D, asking for further studies and so on. But there has been one major downside to all this activity. It has all been temporary, and this is tragic, because R&D is a long-term, risk-laden proposition, and it requires commitment, stability, and consistency in terms of government policymaking.

Now, looking at the above record, you have really got to admit that imposition of the 861 penalty, removal of it on a full basis for 1 year, then removal of it on a 50-percent basis for half a year, then imposition of the penalty again, then removal of it on a 2-year basis for 64 percent, and so on, is not a model of stability.

As to consistency, I think it is ironic that we have heard much testimony today about the incentive provided by the R&D credit and the need for it. At the same time, we leave regulations outstanding that impose a penalty on the same R&D, so we are talking both about an R&D incentive and a penalty coexisting.

Now, as you mentioned, Madam Chair, there has been a development, and it somewhat changes the conclusion of anyone's testimony. The development is news from the Treasury Department that it intends to resolve the section 861 issue by administrative action, which is within its power. Without this development my conclusion would have been to urge the subcommittee to initiate legislation that would once and for all resolve the section 861 R&D issue and bring a permanent solution to this area. But we have been working with the Treasury, and we applaud their sincerity and good faith in dealing with this regulation. We did hear Deputy Assistant Secretary Beerbower testify yesterday that some relief is imminent. So I think I would conclude instead, by asking that this subcommittee stay involved and stay interested because, despite applauding Treasury's sincerity and good faith, after, lo, these dozen years, we are going to believe it when we see it.

If and when those regulations come out, we would ask that the subcommittee stay interested with us in order to make sure that the solution is permanent and that it embodies fair and sound tax and R&D policy.

Thank you very much.

[The prepared statement and study with attachments prepared by Martin N. Baily and Robert Z. Lawrence follow:]

STATEMENT OF RAYMOND J. WIACEK, TAX COUNSEL JONES, DAY, REAVIS & POGUE, WASHINGTON, D.C. ON BEHALF OF EMERGENCY COMMITTEE FOR AMERICAN TRADE

WEDNESDAY, MAY 10, 1995

My name is Raymond J. Wiacek and I am a partner here in Washington with Jones, Day, Reavis & Pogue. I am testifying on behalf of the Emergency Committee for American Trade, or ECAT. ECAT is an organization that represents over 60 large U.S. corporations with vital interests in international tax and trade. Its member companies employ over 5 million people and generate over $1 trillion in annual sales. Its membership includes many R&D-intensive companies who perennially rank among those with the largest commitments to R&D.

I am hear to testify with respect to Treasury Regulations § 1.861-8 as they apply to R&D -- that is, the so-called "861-R&D" regulations. These regulations treat a portion of R&D done in the U.S. as if it were done abroad. The regulations operate, technically, through the foreign tax credit rules, but their effect is the same as denying a deduction for that portion of U.S. R&D "deemed" to be foreign. Of course, no major foreign country grants a deduction for R&D costs incurred in the U.S. just because the U.S. Treasury deems a portion of that R&D to be "foreign." This makes sense. Does anyone really believe that Japan will allow a deduction against Japanese income for engineering salaries paid in Connecticut or chips and semiconductors consumed in California? Would the U.S. let a plant in Ohio assembling Japanese autos reduce its U.S. income taxes for research done on emission controls in Toyota City?

Because they effectively deny an R&D deduction for many U.S. companies, the 861-R&D regulations increase the net cost of R&D performed in the United States, and decrease the overall amount of R&D that can be undertaken for a given level of investment. In 1983, in fact, the Department of the Treasury reported that the 861-R&D rules would reduce overall levels of U.S. R&D. Many R&D-intensive companies also have asked why they shouldn't move some of their R&D abroad, since the Treasury treats some of their R&D as if done there anyway.

The 861-R&D rules have been controversial since their issuance in 1977. They became fully operational in 1980 after a "phase in", and Congress promptly thereafter began enacting short-term "moratoriums" against their application. These now total *nine*.[*] Sometimes these have been full moratoriums, and sometimes 50% or 64% of U.S. R&D was freed from possible allocation to foreign sources. The Treasury, too, has adopted a temporary solution to the 861-R&D problem, holding as a regulatory matter in 1992 that 64% of U.S. R&D need not be subject to foreign allocation.

Each of these actions by Congress and Treasury was accompanied by testimony, economic studies, and legislative reports noting the disincentive to U.S.-R&D, questioning the tax policies inherent in the regulations, calling for further study, and so on. For example, a 1991 study by Baily and Lawrence found that over 300 U.S. corporations, performing approximately 80% of this country's industrial R&D, were penalized by the 861-R&D rules.[**] The bottom line here is that the record on this issue is already long.

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[*] The 861-R&D problem was addressed in the 1981 Act (ERTA), the 1984 Act (DEFRA), the 1985 Act (COBRA), the 1986 Act (TRA), the 1988 Act (TAMRA), the 1989 Act (OBRA), the 1990 Act (OBRA), the 1991 Act (TEA), and the 1993 Act (OBRA).

[**] A copy of this study is attached. It is worth noting that Martin Baily, one of the authors, is now a member of the Council of Economic Advisors.

Unfortunately, no one has permanently resolved this long-acknowledged problem. This is significant, because R&D is a long-term, risk-laden proposition that requires stable and consistent governmental policies. The stability necessary is not demonstrated, however, by policies that remove the 861 penalty on U.S. R&D episodically and for differing short-term periods. The consistency necessary also is lacking where an R&D credit meant to foster R&D is adopted at the same time regulations which penalize R&D are left outstanding.

As a matter of sound tax and R&D policy -- and as a matter of good government -- it is time to resolve once and for all the long-festering 861-R&D problem. ECAT strongly supports adoption of a solution like that embodied in the many moratoriums heretofore passed -- but on a permanent basis. ECAT urges the Subcommittee to demonstrate its commitment to U.S. R&D and sound tax policy by initiating such a solution.

Martin N. Baily

Professor of Economics at the University of Maryland
and Guest Scholar, The Brookings Institution[1]

and

Robert Z. Lawrence
Senior Fellow, The Brookings Institution

At a time of intense foreign competition and slow productivity growth it is essential that the U.S. economy sustain or even strengthen its commitment to commercial R&D. And, recognizing this, there is now broad agreement among policymakers on the need for a permanent R&D tax credit. At the same time, it is vital that other provisions of the U.S. tax code do not offset or reduce the impact of the R&D tax credit. One such provision that would be harmful in its effect on domestic R&D is tax regulation 861-8.

Tax regulation 861-8 requires international companies to attribute part of their U.S. R&D to their foreign-source income. This regulation has been largely suspended since its inception, but the most recent suspension will expire at the end of this year and this would provide an incentive for U.S. companies to move some of their R&D overseas. Given the global operations of many companies and the fact that qualified scientists and engineers are now available in a number of foreign countries, this incentive could lead to a significant reduction of U.S.-based R&D.

It has been argued that the 861-8 provision is narrow in its scope and that only a few companies would be affected by the proposed repeal. In this testimony I report on a study of this question conducted by myself and Robert Z. Lawrence.* We evaluated a sample of 524 companies performing most of U.S. R&D. We find that 304 companies, accounting for 82 percent of sample R&D spending, are likely to be adversely affected if regulation 861-8 were fully implemented.

The Importance of R&D

In earlier studies we have argued that there is a persuasive case for using public policy to encourage commercial R&D.[1] When a U.S. company develops a new technology, it cannot prevent other companies from borrowing or imitating the new developments. Even when there is patent protection, other companies can "invent around" the patent and introduce their own version of the new product.

The fact that a given development in technology has "spillover" benefits for all companies is not bad for the economy. It means that new ideas spread throughout the economy and consumers benefit from the competition among multiple suppliers. In some cases, high-technology companies will even foster the cooperative element of technology development by using cross-licensing agreements or joint-venture R&D projects, as have occurred in the semiconductor industry.

The problem with the spillover of technology is that it reduces the private incentive to perform R&D. Any given company will weigh only the effect on its own profitability of its R&D when deciding how much R&D to perform. It will not include in its calculation the benefits to other companies and to consumers, and the result is

* This study was sponsored by the Council on Research and Technology.

[1]The views expressed here are our own. They do not represent those of the Brookings Institution.

that the private rate of return to R&D is well below the social rate of return. (The private rate is the rate of return to the company that performs the R&D. The social rate includes the private rate plus the rate of return to the economy at large). Since there is this disparity between the private and social rates of return, too little R&D is performed. The economy as a whole, therefore, has a stake in encouraging additional R&D. This argument provides the main rationale for providing a tax credit for R&D and also explains why it is essential to make sure that adverse incentives in one part of the tax code do not undo the favorable effects that have been obtained elsewhere.

Many types of investment are helpful in terms of improving U.S. productivity and competitiveness and for creating jobs, but investment in R&D is special. For most investments, the private and social rates of return are close together, so that we can leave it to the market to ensure that there is an adequate amount done. This is not to deny the importance of policies that keep long term interest rates low and tax burdens reasonable in order to encourage all investment. Rather, it says that there is no need for special treatment for most kinds of investment, indeed it is to be avoided. R&D is different because of the huge gap between private and social rates.

A study by Edwin Mansfield and associates at the University of Pennsylvania in 1977 found that the social rate of return to R&D was over 50 percent compared with about half that for the private rate.[2] There have been numerous follow-up studies of the returns to R&D done since then using Mansfield's approach and using alternative methods. It has been found consistently that the social return to R&D is much higher than the private rate and that there has been no reduction over time in the returns to R&D.[3] Despite the relatively slow growth of the U.S. economy in the last twenty years, it remains the case that commercial R&D is a very good investment for everyone in the economy. Slow economic growth does not seem to have diminished the payoff to R&D.

Based upon arguments such as these, we have strongly supported the R&D tax credit as one way of encouraging additional R&D. And in our own empirical analysis of the impact of the credit that was in effect from 1981-85 we found that it had increased commercial R&D by about $2.5 billion per year. Some other empirical estimates found smaller effects, but there was a clear consensus from a variety of studies that tax incentives for R&D can increase the amount of commercial R&D, and indeed they have done so.[4] The tax treatment of R&D is an important determinant of the amount of R&D performed. Moreover, the efforts to reform the incentive structure of the credit have paid off, so that the proposed permanent R&D credit will provide a surprisingly strong incentive for R&D given its rather small revenue effect.[5] There is now broad agreement in Congress and the White House that an R&D tax credit is desireable.

At this time, however, the Congress is considering how to treat R&D for companies that have significant foreign operations. Tax regulation 861-8 says that part of the U.S. R&D expenses of a U.S. multinational company must be attributed to its foreign activities. This regulation has been largely held in suspension until now, but if it were enforced as written it would provide a substantial incentive for U.S. companies to move R&D overseas, thereby depriving the U.S. economy of much of the benefit of this investment.

The Adverse R&D Tax Incentive Caused by 861-8

The U.S. tax code treats U.S. owned companies on the basis of their world-wide income. Companies must compute both their domestic and their foreign source income and pay U. S. corporate income tax on both parts, with a credit given for the taxes paid to foreign governments in order to avoid double taxation. The U.S. tax code has long specified that companies can take no more in foreign tax credits than the amount that they would have paid in U.S. tax on their foreign income. If the foreign government nevertheless sets a tax rate that is higher than the U.S. rate, the company bears the burden. This prevents a high tax country from passing its taxes to the U.S. Treasury via the foreign tax credit.

For many years the corporate income tax rate in the U.S. was roughly in line with tax rates in the main countries where U.S. multinationals were located. Companies were therefore able to take almost all of their foreign tax payments as credits against their U.S. taxes. There was no particular incentive within the tax code to locate production or other facilities in one country or another. Following the changes that took place in the tax code in the United States in the 1980s, particularly the 1986 changes, this is no longer the case. The tax rate on corporate income in the U.S. is below the rates in most other major countries. This means that more U.S. multinational companies find themselves in the position of having excess foreign tax credits.

Regulation 861-8 states that a company computing its foreign source income must attribute a fraction of its U.S. R&D expenses to its foreign activities, even though all of the R&D is actually being performed in the U.S. For example, a company that had $100 million of R&D or U.S. R&D expenses might have to attribute $20 million to its foreign operations. This raises its domestic source income and its domestic tax liability. But since no foreign government allows companies to deduct R&D expenses incurred in the U.S. from their taxable income within the foreign country, the 861-8 attribution does not correspondingly reduce the amount of foreign taxes paid by the company.

Since many or most U.S. companies with substantial foreign operations are now in an excess foreign tax credit position, the 861-8 regulation, if fully implemented, would increase their overall tax liability and, more importantly, the regulation would also change the calculations of the costs and benefits of locating R&D in different countries. Such companies would then have a very substantial tax incentive to move some of its R&D operations to countries where it has production facilities or where it is earning taxable income. Consider the example that was given earlier and suppose that this company decided to cut its actual U.S. R&D by 20 percent, to $80 million, and to establish a lab overseas with annual spending of $20 million. Its total R&D costs are the same as before, but its tax situation is now very different. The $20 million of foreign spending is now a deductible business expense in the foreign country. If the corporate tax rate overseas were, say, 45 percent, then the company would reduce its foreign tax liability by $9 million (0.45 x 20). The company's U.S. tax liability on its foreign income is unchanged because it has excess foreign tax credits, but its tax liability on its U.S. income would rise by $6.8 million (0.34 x 20). In this example, therefore, the tax benefit to the company represents 11 percent of the amount of R&D shifted (100 x (0.45- 0.34)). For companies with excess foreign tax credits, the 861-8 provision will

generate an important incentive for shifting R&D overseas, the percentage incentive being equal to the difference between the U.S. and foreign corporate income tax rates.

R&D in The U.S. Economy and Overseas

After a number of years in which every new economic statistic seemed to bring more bad news about the performance of the U. S. economy compared to its major competitors, we are now discovering that U.S. industry has more strength than we thought. The trend of productivity growth in U. S. manufacturing has been excellent since the early 1980s. The trade deficit is declining, indeed the most recent figures indicate that the U.S. is running only a very small deficit in manufactured goods. And as we move out of the current recession, even employment in manufacturing should improve. These gains have come, however, despite a continuation of the very fierce foreign competition that now characterizes the world economy. There remain many U.S. industries that are having trouble competing and many more that are succeeding only by making continual efforts to improve their technology, productivity and product quality. Clearly, the ability and willingness of U.S. companies to fund R&D is crucial in determining the outcome of this competitive effort.

The danger of the 861-8 regulation is that it would generate an incentive for many companies to transfer their R&D overseas. This would have a detrimental effect on U.S. economic performance at a critical time for U.S. industry. R&D is particularly important because of its high social rate of return; it gives spillover benefits even to those who are not performing it. To some extent these spillover benefits are international. They can be gained regardless of where the R&D is performed. A new technology developed in Switzerland can be applied in a factory in Ohio. But most of the spillover benefits are local. A scientist or engineer learns by working for one company and then carries this knowledge with him or her to another company. A scientist or engineer based in a U.S. university consults for U.S. companies and then uses this knowledge and experience to help in teaching students. When Toyota developed its innovative methods for auto assembly, this new technology spread fairly quickly to other Japanese auto companies and to other assembly lines. It has taken much longer for U.S. companies to copy the innovation and adapt it to U.S. needs. Many of the spillover benefits of R&D occur within national borders.

The responsiveness of U.S. R&D to the adverse incentives embodied in the 861-8 regulation may be very substantial. The U.S. has been the leader in scientific and engineering research for a long time and it remains the leader today. Twenty years ago, few U.S. companies would have been willing to move much of their R&D overseas because the trained personnel were not available and there was not the same critical mass of research going on. Today, Germany and Japan have a larger fraction of their GNP devoted to civilian R&D than does the U.S. Electronics research can be moved to Japan, pharmaceutical research can be moved to Europe and software development can be moved almost anywhere in the world. Multinational companies are now citizens of the world and will locate their activities where they earn the most return. Indeed the pressure of competition forces them to do this.

We are not suggesting that R&D will suddenly flee the U. S. if the 861-8 exemption is repealed. There are many good reasons for companies to do research here. The real question is: What is going to happen at the margin? If there is a substantial incentive to move R&D overseas or to construct new labs overseas rather than here at home, this is going to happen and U.S. R&D will be adversely affected. We do not know of any clear evidence that shows exactly how large the response is likely to be, but if each dollar of R&D that moves overseas reduces a company's total tax liability by 10 cents or more (as seems to be the case) and if many, many companies are affected by the regulation (as we will show below), then the effect of it is bound to be substantial.

How Many Companies Will Be Affected?

The potential adverse effects of the 861-8 provision on U.S. R&D have been recognized for some time, but their importance has been questioned. One argument is that only a very few companies would be subject to the regulation. Most of the companies performing R&D in the U.S. would not be affected, it is said, and so the bulk of R&D would be unaffected. Moreover, whenever provisions of the tax code affect only a very few companies, there is concern that the case for tax relief reflects merely special pleading by these few companies, rather than being based upon true public policy concerns.

The issues, then, are whether regulation 861-8 affects a small or a large number of firms and whether it applies to a small or large fraction of total corporate R&D. We have addressed these questions by looking at 743 manufacturing companies from a COMPUSTAT data base. This data base is a standard source for the analysis of U.S. business; it is prepared by Standard and Poor's from company reports and SEC filings.[4]

Of the 743 companies in the sample, 524 reported that they performed R&D and the total of their reported spending was $51.581 billion in 1987 and $56.842 in 1988. These figures are close to 90 percent of the National Science Foundation's figures for total industry-funded R&D for those years. The company data in the COMPUSTAT file are not exactly comparable to the NSF figures, because the NSF excludes R&D performed by U. S. companies overseas and because some government-funded R&D may be included in the COMPUSTAT figures. But nonetheless, these totals indicate that the firms in our sample cover the great majority of U.S. R&D.

It is worth noting immediately that the percentage of the companies that performed R&D was very high indeed -- over 70 percent. R&D is not an activity restricted to a small group of companies in the U.S. economy. Over two-thirds of our large manufacturing companies are R&D performers.

We then set up a series of criteria to determine which of the 524 R&D performers would be affected by the 861-8 regulation. We assumed that a company will be affected by 861-8 if it conducts R&D in the United States, is profitable, has foreign income and pays "high" foreign taxes. These criteria indicated that 312 companies would have been affected by the provision either in 1987 or 1988 if it had been in effect. This figure is conservative in that it excludes several companies that failed to report all of the

relevant information to COMPUSTAT, even though some of these companies may in fact be affected by the regulation. The 312 companies obtained by the above criteria did include, however, 8 major defense contractors that are probably not affected by 861-8 because they do not have enough high-taxed foreign source income. Thus the final tally was that 304 of the companies are estimated to be affected by 861-8. This means that of the companies in the sample that perform R&D, 58 percent are affected. In 1988, these affected companies performed $46.450 billion of R&D, equal to 82 percent of the sample R&D in 1988. It is clear that the 861 regulation is one that affects a large number of companies and a large fraction of total R&D.[7] The results of the analysis are summarized in Table 1.

The Extent to Which U.S. R&D is Concentrated

We have shown that a large number of companies would be affected by a repeal of the 861-8 exemption, so that this is not an issue that is of concern only to a few companies. However, there are a few companies that account for a large fraction of the tax effect of the regulation. Even though the regulation would affect many firms, its quantitative impact is rather concentrated and the reason for this is that R&D itself is very concentrated.

R&D is very risky, the payoffs often accrue over the very long term and there are advantages to operating at large scale. It is in the nature of the R&D activity itself that it will be concentrated in large firms. We often hear of the small firms and the pioneering innovators that have made major advances in technology without having large labs or large- scale resources. And these stories are indeed correct. However, these small firms and small labs generally have to team up with large firms in order to develop their products and processes. Most of the cost of R&D comes in the development stage, not when the invention is first made. If we are to provide support and incentives for R&D in the U.S. economy, inevitably this means the greater part of those benefits will flow to large firms.

One way that we know that concentration in R&D is to be expected is that we see the same pattern of concentration in other countries. Figure 1 gives the distribution of R&D spending in the 70 largest U.S. R&D spenders and the 70 largest Japanese spenders. We see a very similar pattern of concentration in the two countries, actually with somewhat higher concentration in Japan than in the U.S. The largest 15 performers in Japan account for about 65 percent of the total R&D performed by the full 70 firms. The corresponding figure for the U.S. companies is about 55 percent.

Conclusions

- It is important to support R&D spending by U.S. companies and it is important that this spending occur here at home.

- Failure to renew the suspension of the 861-8 exemption would result in an incentive for U.S. companies with international operations to shift some of their R&D spending overseas.

- Our study of the largest manufacturing companies in the U.S. indicated that 58 percent of them, over 300 out of 524 R&D performers, are likely to be affected by full implementation of the 861-8 regulation. These affected companies performed $46.45 billion of R&D in 1988 -- an amount equal to 82 percent of the R&D in our sample (and 78.5 percent of all industry-funded R&D in the U.S.).

- The impact of the 861-8 regulation is concentrated on large firms because R&D itself is concentrated. The concentration of R&D in the U.S. economy is less than R&D concentration in Japan.

Footnotes

1. Martin Neil Baily and Robert Z. Lawrence with DRI Inc., The Need for a Permanent Tax Credit for Industrial Research and Development. Study sponsored by the Coalition for the Advancement of Technology, Washington D.C., February 1985; and Tax Policies for Innovation and Competitiveness. Study sponsored by the Council on Research and Technology, Washington D.C. April 1987.

2. Edwin Mansfield et al., "Social and Private Rates of Return From Industrial Innovation, " Quarterly Journal of Economics, 1977, pp. 22140.

3. Edwin Mansfield, "The Microeconomics of Technological Innovation, " in Ralph Landau and Nathan Rosenberg, eds., The Positive Sum Strategy: Harnessing Technology for Economic Growth, Washington D.C., National Academy Press, 1986; Frank Lichtenberg and Donald Siegel, "Using Linked Census R&D-LED Data to Analyze the Effect of R&D Investment on Total Factor Productivity Growth," Columbia University, January 1987.

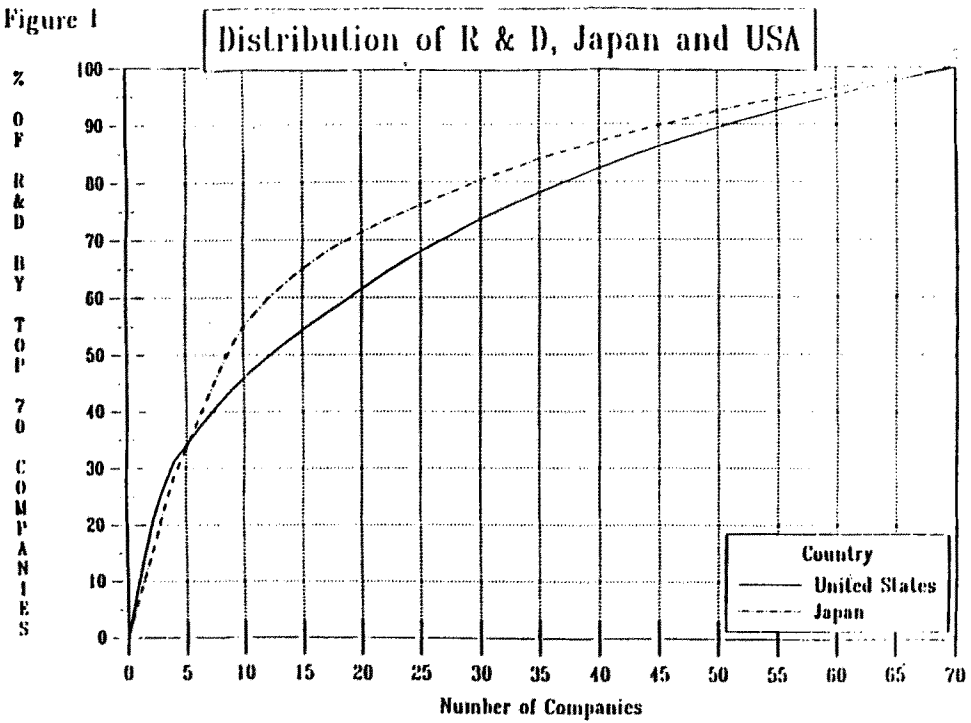
4. We review the studies in Baily and Lawrence 1987, op. cit.

5. Martin Neil Baily and Robert Z. Lawrence, The Incentive Effects of the New R&E Tax Credit. Study sponsored by the Council on Research and Technology, Washington, D.C., July, 1990.

6. We understand that R&D for financial and SEC purposes differs somewhat from R&D for tax purposes, but we believe that the COMPUSTAT data provide a reasonable approximation for purposes of this analysis.

7. In order to check our criteria, we provided the list of the largest 50 R&D performers in our sample to Mr. Raymond Wiacek of Jones, Day, Reavis and Pogue, an expert on 861-8. We asked him to indicate which companies on the list would be affected by the regulation based on his knowledge of the companies and the regulation. His response allowed us to determine how well the criteria were working in marking the affected companies. The agreement was excellent. There were only four differences in classification, one of which came from a "cost-sharing" company and three of which were defense companies. As we say in the text, we thereafter eliminated all of the major defense contractors from our list of affected companies.

Figure 1



Source: Japanese data from The Japan Company Handbook, by Toyo Keizai Shinposha, 1987.
U.S. data from Standard & Poor's Industrial Compustat Database.

Note: Japanese data are for the 1987 fiscal year, U.S. data for the 1987 calendar year.

TABLE 1: SUMMARY OF INVESTIGATION INTO MANUFACTURING R&D, 1987–88

Category	Number of companies	Percent of the sample's 1988 R&D	Dollars in millions, 1988 R&D in each category
Total U.S. R&D expenditures, 1988	.....	.....	$90,600
Total Private R&D in 1988 [1]	.....	.....	59,100
Manufacturing companies which were examined	743	.....	.....
Companies with no R&D 1987 or 1988	−219	.....	.....
Manufacturing Companies with R&D (the sample)	524	100.0	[2] 56,842
Tax data not available	−65	10.1	5,758
Companies with R&D and tax data	459	89.9	51,084
Paid no foreign taxes in 1987 or 1988	−109	2.4	1,337
Paid foreign taxes but no Federal taxes	−38	1.3	745
Total companies with R&D and both foreign and Federal tax payments in 1987 or 1988	312	86.2	49,002
Of which are major defense contractors not included elsewhere	−8	4.5	2,552
Nondefense companies	304	81.7	46,450

[1] Expenditures funded by private companies, excluding all federally funded R&D centers administered by private companies. 1988 figure is an NSF estimate.

[2] R&D in the sample represents 96.2 percent of all private R&D done in the United States.

Sources: Company R&D from Standard & Poor's Industrial Compustat Database. Total national R&D from NSF, Science & Engineering Indicators, 1989.

STATEMENT OF ROBERT H. GREEN, VICE PRESIDENT, TAX POLICY, NATIONAL FOREIGN TRADE COUNCIL, INC.

Mr. GREEN. Thank you, Madam Chair, and members of the subcommittee. My name is Bob Green, and I am vice president for Tax Policy of the NFTC, National Foreign Trade Council, Inc. I appreciate the opportunity to testify before the subcommittee on the 861 allocation rules and the 1977 regulations. I have submitted a very detailed written statement, which I ask to be incorporated in the record. In light of the fact that a number of the witnesses on the panel have covered the points that I intended to address during my testimony, I will briefly summarize those points for you.

Our basic position on the 861 allocation issue is that we would urge the Treasury to finalize regulations that provide a permanent solution that will provide a reasonable allocation between domestic and foreign source of the R&E expenses to operate in tandem with the R&D tax credit in a manner that does not undermine its vitality. I am very encouraged, as Ray Wiacek said, about the effort that the Treasury has undertaken to pursue a regulatory solution to this problem.

Ray is more familiar with the history of this issue, perhaps, than anyone; and because of the sporadic nature of the solution to this issue over the years, I think it behooves all of us to monitor the Treasury solution to this problem very closely and to share with the subcommittee our input and assessment of the substance of the regulations when it is released. But I commend the Treasury for the initiative.

Just by way of background, the NFTC is an organization of roughly 500 companies, 90 percent of which are U.S.-owned. The organization's members are engaged in activities that span the spectrum of commercial activities from industrial, commercial, financial, and service activities throughout the world. In this respect, the need to establish a permanent solution of the R&E allocation rules is a crucial element in the ability of these companies to compete in the growth markets around the world.

Companies sitting around the table here, who have spoken, and many others in my organization are very active in the R&E area and in the growth areas of the world; China, Indonesia, many of the Pacific rim countries are areas where R&E activities are particularly important to compete in those marketplaces.

I think Ray Wiacek has amply demonstrated the nature of the history of the 861 R&E allocation rule, which is one of uncertainty, instability, and lack of finality. One of the things that you can clearly count upon with companies is when they have tried to plan their business investments in a particular country, they attempt to analyze and assess the return on that investment. That is especially difficult to do when you are uncertain about both the U.S. consequences of your R&E investment and the foreign treatment of that particular investment. For that reason, the permanency issue is paramount, and we urge the subcommittee to work with the Treasury to try to come up with a solution that makes sense.

The rest of my remarks are contained in my written statement. I am delighted to testify here today, and I am willing to answer any questions that the subcommittee has.

[The prepared statement follows:]

National Foreign Trade Council, Inc.

Prepared Statement Submitted to the Subcommittee on Oversight of the Committee on Ways and Means U.S. House of Representatives

May 10, 1995

Madame Chairman and Members of the Subcommittee:

The National Foreign Trade Council, Inc. (NFTC) appreciates the opportunity to submit its written comments on the issue of the research and experimentation expense allocation rules contained in Treasury regulations Section 1.861-8(e)(3). While a more detailed discussion of our position is described below, the NFTC would respectfully urge the Treasury to resolve this issue permanently by regulation to provide for a 64 percent allocation to U.S. source income for R&D expenses conducted in the U.S., or, alternatively to provide at least for the 50 percent apportionment contained in the OBRA Legislation of 1993. If a regulatory solution cannot be achieved, then the NFTC would urge Congress to enact a permanent, legislative resolution of this issue by providing for allocation of at least 50 percent of R&D expenses incurred in the U.S. to U.S. source income.

The NFTC, organized in 1914, is an association of over 500 U.S. business enterprises engaged in all aspects of international trade and investment. The NFTC membership is actively engaged in a broad spectrum of industrial, commercial, financial, and service activities around the world. The NFTC's sole agenda is to foster an environment through tax and trade policy that permits U.S. companies to be dynamic and effective competitors in the international business arena. In this respect, the need to establish a permanent solution to the R&E allocation rules is a crucial element to further the ability of U.S. companies to be competitive in the growth markets of the international economy.

Background

The history of the 861 R&E allocation issue is one of uncertainty, instability, and lack of finality. Since the issuance of the 1977 regulations that proposed a maximum allocation of 30 percent to U.S. source for R&D expenses conducted in the U.S., there have been numerous efforts of a temporary nature, both legislative and regulatory, to address the R&E allocation question.

To briefly summarize the history of the R&E allocation issue after issuance of the 1977 regulations, Congress imposed a moratorium on implementation of the 1977 regulations beginning in 1981 and extending through 1986. During that period, U.S. companies were permitted to allocate the entirety of their R&D expenses to U.S. source income. The rule permitting all expenses to be allocated to U.S. source was modified in 1987 to allow a 50 percent allocation to U.S. source income. For most of the next five years (1988 - 1992), Congress passed legislation that provided for a 64 percent allocation of R&E expense to U.S. source income.

In 1992, the Chairmen of the Tax-Writing Committees sent a letter to then Treasury Secretary Brady urging that the 64 percent allocation rule be extended by administrative fiat. The Treasury Department favorably responded to this request, but only for a temporary period of 18 months. The 1993 OBRA legislation modified the administrative fiat provided by the Treasury Department to allow a maximum of 50 percent of R&D expenses to be allocated to U.S. source income, but the 1993 legislation expired December 31, 1994. Unless an administrative or legislative solution is obtained, the 1977 regulations will apply for 1995 and all subsequent taxable years.

Proposed Solution

The NFTC believes that the preferred solution to the R&E allocation issue is for the Treasury Department to revise the 1977 regulations to provide for a 64 percent allocation of R&E expense to U.S. source income, or, alternatively at least to adopt the 50 percent allocation rule contained in the 1993 OBRA legislation. If the R&E allocation issue cannot be satisfactorily resolved at the regulatory level, then the NFTC would urge that the Congress enact legislation to extend on a permanent basis the 50 percent allocation rule adopted in the 1993 legislation. The NFTC wishes to emphasize the need to provide a permanent solution, either regulatory or legislative, that is fair in its treatment of R&E expense allocation relative to foreign companies against which U.S. businesses must compete.

Reasons Underlying the Need for a Solution

There are numerous, compelling reasons for either the Treasury Department or the Congress to act expeditiously to establish rules that would allocate R&E expenses to U.S. source income in a reasonable manner. These include:

1. R&E expenses allocated to foreign source Income under U.S. rules are disallowed as a deduction in foreign countries. Any portion of the R&E expense incurred in the U.S. that is allocated to foreign source income is disallowed as a deduction in the foreign country. When this scenario occurs, the result is to impose double taxation on U.S. companies. Foreign companies against which U.S. businesses compete for market share are generally permitted to deduct all of the R&E expenses performed in their own country.

   To avoid the double taxation that ensues when R&E expenses are allocated to foreign source income, U.S companies may consider the possibility of conducting their R&E expense in foreign jurisdictions. While a decision to relocate is only undertaken after weighing all business-related factors, U.S. policy should encourage U.S. companies to perform R&E expense in the U.S. Instead, present U.S. policy causes U.S. companies to at least to consider the alternatives of performing R&E elsewhere.

2. Allocation of R&E Expenses to Foreign Source Income Undermine the Purposes Underlying the Research and Development Tax Credit. The research and development tax credit (R&D) was enacted by Congress to promote the performance of research and development in the United States. It is widely recognized that research and development in the United States has declined relative to the R&D activities in most industrialized countries, in which the foreign competitors of U.S. companies are primarily based. The tax policy in the U.S. that encourages the performance of R&D expenses in this country works in concert with or is complimentary to the R&D tax credit mechanism. Conversely, the concept underlying the R&D tax credit is undermined to the extent that a significant portion of R&E allocation expense is allocated to foreign source income.

3. Reasonable R&E Rules and Effective R&D Tax Credit Enhance U.S. Competitiveness in a Global Economy. Adoption of allocation rules that provide an allocation of up to 64 percent of R&E expenses to U.S. source income promote a competitiveness of U.S. companies that are growth oriented and effectively compete in the global economy. The companies affected by both the R&E rules and the R&D tax credit compete in against their foreign counterparts in the emerging market places of the world/i.e./China, Indonesia, etc. It can unequivocally be stated that strengthen these two components of U.S. tax policy (the R&D tax credit and R&E allocation rules) will enhance the competitiveness of U.S. companies and lead to greater job creation.

4. The Solution to the R&E Allocation Problem should be Permanent in Nature. As the of the R&E allocation debate amply demonstrates, there is a compelling need to devise a permanent solution to the R&E allocation issue that permits U.S. companies to effectively compete in foreign jurisdictions. While the NFTC preference would be for the Treasury to revise the 1977 regulations in a manner consistent with our recommendations, the important point to stress is the need for a permanent and not a temporary solution to what has been an intractable problem. It is extremely difficult for U.S. companies to plan their business investments in foreign jurisdiction when a vital component of the tax planning surrounding investments of this nature, namely, the treatment of R&E expenses, is uncertain and unreliable. We urge the Treasury and the Congress to collaborate to produce a permanent solution to this issue.

The forgoing reflect our comments on the 861 R&E allocation issue. Please let us know if you need further information or if there is any other manner in which we may be of assistance.

Chairman JOHNSON. Thank you.

This is a subject we are going to have to come back to as soon as Treasury releases their regulations, so I invite all of you to share your comments on those when they are released. But I would like to hear your comments on Ms. Kaye's proposal. It may be worth looking at that, even if the regulations are far better than anything we have had to date.

One of the things that is becoming increasingly clear to the subcommittee as a whole is that if we don't simplify our tax structure, then we leave ourselves at a terrible disadvantage. Also, frankly, it is not only so complex that you can't understand it without a lot of tax experts, it is harder and harder for Members to understand the implications of actions that are proposed; and this is a perfect example of the area.

Imagine solving a problem for 10 years by imposing a moratorium. This is not exactly digging in and fixing. So I think we do have an obligation and an opportunity right now to evaluate the Treasury's effort because the Treasury has made a very positive effort.

There is no question that they are trying to reach out and make this thing work in a way that is fair and equitable. I am not sure from what I just heard and in preparation that the law is written in such a way that they can avoid the double taxation that is destructive.

In one of the preceding panels, while the speaker didn't quote that part of their testimony, apparently there is now pretty good evidence of an increasing flow of American R&D abroad, and I would assume that that has something to do with this portion of the law. At any rate, I would be interested in your comments on Miss Kaye's proposal which was, if I may remind you, that the allocation of R&D expense to foreign-source income should only occur where deductible in a foreign jurisdiction.

Comments?

Mr. WARREN. I guess I can offer a few comments to begin with. Speaking for TRW, in particular, and I believe for the Electronic Industries Association——

Chairman JOHNSON. Mr. Warren, if I could defer the answer to my question, Mr. Portman, who has been with us off and on now many, many hours has a speech in 5 minutes. I am going to yield to him for his question first.

Mr. PORTMAN. You are very kind. I appreciate it, and with apologies to my colleague, Mr. Cardin.

My question was practically the same as Mrs. Johnson's; it usually is. I tend to be sympathetic with what was stated here today. I think I understand the issue fairly well, but one thing that didn't come across clearly to me was the fact that I think the consequence of all this, which is a significant policy consequence, is that companies have very little incentive to keep R&D here if they fall into this trap, and therefore would have at least no disincentive to go overseas with their R&D, assuming most of it is getting allocated, or a significant part to their foreign income.

I guess that is part of what Mr. Warren might be responding to, in responding to that specific proposal of only having the allocation apply when it is deductible to foreign-source income. I would ask

Mr. Warren to proceed with his answer, but perhaps the other panelists can think about that question and whether that is a realistic consequence of the current law.

Mr. WARREN. The problem with the 861 allocation is just what was stated. It encourages movement of research offshore. It is a very real disincentive. It works, as you have heard other witnesses say, in direct opposition to an R&E tax credit, which is designed to encourage research.

I listened to the proposal that was just outlined with much interest. I think, from a company standpoint, from an industry standpoint, our interest has focused on trying to resolve this from a very real economic standpoint, and in the process we have gone through a series of moratoriums ranging from 100 percent to, I think most recently, 50 percent.

The proposal, as outlined, would offer a number of theoretically unique characteristics that I think and would hope would be considered by the Treasury Department. It is certainly a much more theoretically pure approach than a compromise resolution that layers additional complexity on top of regulations that are overly complex to begin with.

The 1977 regulations are very difficult to apply to begin with. Any legislative solution or regulatory solution that uses that as a starting point will have to end up with a very complex solution. What we need is simplification, though most importantly, we need an economic resolution that encourages U.S.-based research.

Chairman JOHNSON. Other comments?

Yes, Mr. Wiacek.

Mr. WIACEK. There were, I think, several questions embodied in the two that were asked. As to foreign R&D, it has often been said by the affected companies that if Treasury is going to treat their R&D as if it were done abroad and they get no deduction for it, why shouldn't they do it over there instead and get the deduction and remove the disincentive?

Now, academic studies have found it difficult to quantify the direct effect of the regulation on the export of R&D, although the studies do show that there is an effect. Because many affected companies are so large and R&D decisions involve so many other considerations, I don't know if anyone, given the burden of proof, could come through with really demonstrable proof. But the companies all have the capability to put the R&D abroad because they have foreign R&D facilities. R&D decisions are made at the margins, and they are made on an after-tax basis so that R&D tax costs are certainly part of the equation.

I would caution that we shouldn't think of all R&D done abroad as something bad or wrong, because the United States has no monopoly on brain power. We want our capital and our companies to employ those scientists or those people who achieve technological breakthroughs wherever they may be in the world.

As to Professor Kaye's proposal, an off-the-cuff reaction would be that we would favor it. I can't tell you whether we would support it as a proposal per se or merely as proof of what we have been saying. The bottom line is that no member of ECAT has ever received a deduction for any 861 allocation. At one time we did a

study and the companies represented in it account for about 80 percent of U.S. industrial R&D.

So the upshot of Professor Kaye's proposal would be a 100-percent moratorium or elimination of this regulation, which would be better than what we have come to expect, in light of the many years of hurly-burly that has produced compromises and questionable temporary solutions.

To illustrate, do any of you know where the 64-percent solution came from? It was a solution that was to be two-thirds/one-third or rounded at 67/33. But at 3 o'clock in the morning that left us a little short on revenue so that 3 percentage points got knocked off; thus, the famous 64-percent solution. That is the type of thing that has been involved.

Professor Kaye's solution would be a 100-percent one. The interesting thing also about it would be that it would put the pressure where it should be, on Treasury. If Treasury really thinks that foreign countries should recognize the theoretical underpinnings of the section 861 tax policy that R&D done here benefits the worldwide enterprise, rather than telling U.S. companies to go over to Germany or Japan and get a deduction for research done in the United States, let Treasury, by treaty or otherwise, pressure these countries, because right now the pressure is on us and all it results in is double taxation.

So I think the bottom line is that her proposal would achieve a correct and fantastic result. Whether it is adopted as the solution or whether it is proof of what we have been saying, it is a good proposal in either case.

Chairman JOHNSON. Thank you.

Mr. Cardin.

Mr. CARDIN. Thank you, Madam Chairman. Let me thank all of our panelists for their testimony. This is clearly an issue that cries out for a permanent solution and not one that changes at the whim of whether we need to change it by 3 percentage points in order to work out the budget for that particular year. It is one that we really should look for permanent allocation rules as relates to these expenses.

I share the views of the other members of the subcommittee who have said we need to take a look at this when we develop permanent allocation rules as to what rewards U.S. companies for the research being done in the United States. I understand that there are advantages to U.S. operations for research done outside of the United States, but I think as far as tax policy here is concerned, we need to take a look at making sure that we encourage research here in the United States; and I have found your testimonies to be very helpful to us in that regard.

As we look at specific recommendations that come in from Treasury, we would welcome your continued working with our subcommittee so that we can try to come out with allocation rules which will reward your companies in performing research here in the United States and being as competitive as you can be in the worldwide economy atmosphere.

Thank you.

Chairman JOHNSON. I thank the panel very much, and I look forward to your response to the regulations.

Ms. Kaye, if you want to submit to us any further detail on your proposal, legal language, I would be happy to look at it. Thank you.

Thank you for your help today. The hearing stands adjourned.

[Whereupon, at 2:03 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

HEARING BEFORE THE
SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

on

THE RESEARCH AND EXPERIMENTATION TAX CREDIT

May 10, 1995

Written Statement
of
The American Automobile Manufacturers Association
Submitted by Price Waterhouse LLP

Price Waterhouse LLP, on behalf of the American Automobile Manufacturers Association (AAMA), appreciates the opportunity to submit this written statement concerning the research and experimentation tax credit. AAMA's member companies -- Chrysler Corporation, Ford Motor Company, and General Motors Corporation -- annually expend large amounts of capital on research and experimental activities to maintain their competitive position in the world market.

The competitive strength of the U.S. automobile manufacturing industry depends on continuing technological development. AAMA thus strongly supports a permanent research credit as critical to promoting investments in research and experimental activities that lead to technological advances. The reasons for the research credit, as expressed by Congress in enacting the credit in 1981 and in subsequent legislation extending the credit, remain equally valid today. These include encouraging companies to allocate scarce investment funds to costly research and experimental activities.

The effectiveness of the research credit hinges in part on sound administration of the rules governing the credit's operation. It is particularly important that taxpayers and the IRS agree on the scope of the credit. Unfortunately, the IRS has not proposed regulations under section 41 since the Tax Reform Act of 1986 changes to the credit. Over the past nine years, IRS agents operating without guidance appear to have adopted differing views as to what constitutes credit-eligible activities and expenses. This results in restrictive audit practices and lack of uniformity creating uncertainty for companies as they plan their research programs.

Credit-eligible expenses

The General Accounting Office (GAO) in recent reports on the research tax credit has concluded that confusion over the definition of "qualified research" has made the credit more difficult for the IRS to administer. In the absence of clarifying regulations, AAMA agrees with this assessment.

AAMA is concerned, however, about a presupposition in the GAO reports that research must result in "innovative" products or processes in order to qualify for the section 41 credit. A 1994 GAO report states, "The requirement that research be truly innovative to

qualify for the credit will mean that administering the credit will continue to be labor-intensive and to involve judgments about highly technical matters."[1] A 1995 report states, "IRS officials reported that they were required to make difficult technical judgments in their audits concerning whether research was directed to produce truly innovative products or processes."[2] The 1995 report summarizes, "Innovative research qualifies for the credit; routine research does not."[3]

Contrary to the presupposition in the GAO reports, there is no general standard that the results of research activities must be "truly innovative" in order to qualify for the credit. Indeed, the only reference to any type of innovation standard in the section 41 statute or the 1986 Act conference agreement relates to the credit-eligibility of costs of developing internal-use software. The 1986 Act conference agreement states that Congress intends that Treasury issue regulations providing that internal-use software, in order to qualify for the credit, must be "innovative (as where the software results in a reduction in cost, or improvement in speed, that is substantial and economically significant)."[4] The fact that Congress specified an innovation test in order for internal-use software to qualify for the credit makes clear that there is no general innovation standard applicable to other development costs.

A generally applicable innovation standard indeed would be difficult to administer. IRS agents and taxpayers would be embroiled in continuous disputes assessing the relative technological advances made by one product or component in relation to another. Congress did not intend such a restriction when it enacted the 1986 Act's targeting changes to the credit.

Instead, the 1986 Act definition of "qualified research" eligible for the credit starts with a requirement of section 174 qualification (relating to the treatment of costs as deductible R&E expenditures) and provides further clarifications. In order for expenditures to be eligible for the research credit, the 1986 Act provided that (1) the research activities must be aimed at discovering information that is technological in nature, (2) substantially all the research activities must relate to functional aspects of the product, process, etc., and (3) substantially all the research activities must constitute elements of a "process of experimentation."

These rules focus on the activities undertaken by the taxpayer -- e.g., whether the activities were part of a process of experimentation -- not on the product resulting from the research activities. There is no requirement that products or processes be innovative; the tests envision that the credit also is available with respect to research activities that support evolutionary improvements to products and processes.

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[1]Pharmaceutical Industry's Use of the Research Tax Credit (GAO/GGD-94-139, May 1994), p. 23.

[2]Additional Information on the Research Tax Credit (GAO/T-GGD-95-161, May 1995), p. 13.

[3]Id. at 1.

[4]H.R. Rep. No. 99-841, 99th Cong., 2d Sess. (Sept. 18, 1986) at II-73.

Section 41 regulations

IRS regulations clarifying the definition of credit-eligible activities and expenses would help taxpayers plan their research programs and would minimize many disputes currently arising with respect to the credit. It is important that any regulations maintain the scope of credit-eligibility that was outlined by Congress in 1986. As a general rule, the section 41 regulations should embrace a principle envisioned by the 1986 Act conference agreement and set forth in final regulations under section 174. These regulations provide that the determination whether product development costs qualify as research or experimental is based on "the nature of the activities," rather than on the nature of the product or improvement being developed or the level of technological advancement the product or improvement represents.

The final section 174 regulations, issued in September 1994, were the product of a dialogue between the IRS and affected taxpayers, including AAMA's member companies. A similarly reasoned approach needs to be taken -- and commenced soon -- in formulating guidance on the section 41 research credit. In the absence of regulations, uncertainty over the definition of credit-eligible expenses will leave the IRS and taxpayers enmeshed in resource-consuming audit disputes and will create uncertainties that diminish the incentive effect of the research credit.

James R. Shanahan, Jr.
Washington National Tax Services
Price Waterhouse LLP
Washington, D.C.

STATEMENT OF

THE AMERICAN GAS ASSOCIATION

I. Introduction

Madame Chairwoman and Members of the Subcommittee, thank you for the opportunity to submit this statement on ways in which our tax code can promote needed private sector research and development (R&D).

The American Gas Association (A.G.A.) is a national trade association comprising some 275 natural gas distribution and transmission companies throughout the United States, Canada and Mexico. These firms deliver gas energy from the wellhead, and various unconventional sources, to the burner tip, serving over 58 million customers. Collectively, 90 percent of the gas consumers in this country are served by A.G.A.'s members.

A.G.A. supports the extension of the existing research and experimentation (R&E) tax credit in Internal Revenue Code (IRC) Section 41, which expires on June 30, 1995. Additionally, we strongly support modifying existing law in IRC Section 41 by providing an optional 20 percent flat credit for expenditures made to support research that is done collaboratively for the public benefit by not-for profit organizations. According to this modification, a flat 20 percent collaborative R&E credit would be provided for energy conservation, safety, environmental, manufacturing process or other research of public importance conducted by teams of companies or utilities through a non-profit scientific research organization. This modification would complement, but not supplant, the existing incremental tax credit.

The R&E tax credit is more important now than at any time in its history. International competition is growing. Industry is forced to cut expenses wherever possible. The federal government is cutting its investment in energy-related R&D. Federal policies supporting a strong private sector commitment to R&D need to be enhanced. In order for the R&E credit to effectively promote new and relevant research, it must be designed in a way to encourage collaboration. Collaboration is often the most efficient means of conducting research and achieving the best results with scarce R&D resources.

Many of A.G.A.'s members are members of the Gas Research Institute (GRI), which was founded in 1976 by a committee of members of the boards of directors of A.G.A. and the Interstate Natural Gas Association of America. GRI is the leading research, development and demonstration management organization of the natural gas industry. Its mission is to discover, develop and deploy technologies and information that measurably benefit gas customers and enhance the value of gas energy service. GRI accomplishes its mission by planning and managing a consumer sensitive, cooperative research program emphasizing technology transfer. GRI conducts its R&D program in cooperation with its member companies and other participants who provide funding as well as input for the programs content and direction.

GRI is funded by a surcharge collected by its interstate pipeline member companies through tariffs approved by the Federal Energy Regulatory Commission (FERC) for natural gas transportation services. GRI is a medium through which a number of our members can sponsor industry-related research in both pure and applied sciences.

II. Benefits of a Collaborative R&E Tax Credit

A flat 20 percent tax credit would provide companies contributing to consortia a significantly greater incentive than the current credit. This modification will complement and enhance, rather than interfere with R&D conducted pursuant to the current law. A collaborative credit would encourage a greater private sector response to possible

reductions in government-sponsored research. The collaborative credit would be a stimulus for new research, as is the goal of present law. Such a credit would clearly benefit natural gas and electric power research that is essential to all other manufacturing and consumer applications.

The importance of R&D can best be described in terms of who benefits. Natural gas industry sponsored R&D results in lower costs and higher-quality gas energy services for gas consumers. Ultimately, producers, pipelines, distribution companies, manufacturers and customers benefit from new technologies that increase the availability of cost-competitive gas supplies; provide safer, more cost-effective gas industry operations; develop uses for natural gas that provide cost or performance advantages over other energy sources and enhance environmental quality.

Consortia research is far more efficient on a dollar spent-dollar deployed R&D basis. When firms join R&D consortia, they reduce redundancies, spread risks and costs, share in the results achieved and promote technology. In consortia research, overhead is reduced to that of managing the collaborative pathways and decisions on research subjects.

In addition to reducing the duplication of research and stimulating new R&D, a consortia could prove to be a fertile and robust environment for the deployment of new technology. The consortia environment combines both suppliers and users of the R&D such that the widest market for the implementation of technology is assured. By encouraging collaboration, the credit would help speed the discovery of innovations because it would serve to pool the experiences of a variety of firms.

Technology deployment is the means by which advanced manufacturing technologies, either equipment, software, processes or management techniques, find their way from development to practical application. Sustained, expeditious and effective technology deployment is essential for R&D to have a practical positive impact.

III. Current R&E Tax Credit Discourages Collaborative Research

While the current R&E tax credit was enacted to encourage the kinds of research that are conducted by research organizations such as GRI, it has failed to encourage collaborative R&E conducted by a consortium. The tax law does not adequately address several issues that affect collaborative research and the full use of the R&E tax credit is being restricted in ways not contemplated by Congress.

Typically, consortium members pool their funds and contract with third party research organizations to carry out the research. Current law limits the tax credit to 65 percent of the amounts paid by the taxpayer for contract research conducted on the taxpayer's behalf. The outside contract research provision was placed in the Tax Code to ensure that the credit would not reward overhead beyond the scope of the R&D definition. Therefore, there is less incentive for consortia-based R&E than R&E conducted by individual companies at their own research facilities.

The benefits of the credit for collaborative research are restricted further because of considerations relating to the "carrying on a trade or business requirement" of Section 41.[1] For example, GRI conducts research on the energy efficient use of natural gas in home furnaces, industrial processes and commercial cooling. Since this research does not have a direct link to an interstate pipeline's business of delivering natural gas, the Internal Revenue Service has determined that current law does not allow this research to qualify for the tax credit.[2] These issues present a major disincentive for collaborative research contributions.

Current law encourages R&D only above a base amount because it seeks to reward R&D that would not otherwise occur in the absence of the credit. However, the base beyond which the credit applies is determined on an historic ratio of R&D to sales. This concept may be appropriate when applied to an individual companies focusing on product innovation. When this concept is applied to utilities and their energy partners, the economic assumptions underlying the incremental credit are incorrect.

First, the connection between R&D and gross receipts in the utility industry is not always present. While product R&D is conducted with the goal of increased sales, utility research will often not lead to increased territory or product sales. If research is related to energy efficiency, it may even lead to the opposite result -- less energy consumption and lower gross receipts -- as natural gas appliances, gas fired electric generation, and transmission are made more efficient.

Second, basing the tax incentive on incremental increases in R&D is not appropriate in the context of consortia research. On a national level, collaborative R&D is only a small fraction of all R&D being spent. When firms collaborate, R&D is done in the most efficient manner since costs and benefits are pooled, and duplication is reduced. When firms collaborate, some duplicative research they would have done on an individual basis (and for which they may receive the incremental credit), is done more efficiently. Applying the incremental approach to consortia research places an unnecessary and socially counterproductive barrier on collaboration.

Unique Nature of Research by Utilities

Some natural gas R&D projects have significant costs, high risks and, at best, a long-term return on investment. Additionally, much of the research done by GRI involves the development of new processes or uses for natural gas. While this type of R&D has greater overall benefits to the industry, it is unlikely to be conducted by one gas company who cannot typically recapture the R&D dollars by selling the new process or use. The competitive environment inaugurated by the deregulation of the natural gas industry has made it more difficult to sponsor R&D that does not involve an immediate return on investment.

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[1] Section 41 of the Internal Revenue Code requires that "qualified research expenses" include certain amounts paid or incurred by the taxpayer during the taxable year in carrying on any trade or business of the taxpayer.

[2] In Regulation Section 1.41-2, the Internal Revenue Service has stated that a "contract research expense of the taxpayer is not a qualified research expense if the product or result of the research is intended to be transferred to another in return for license or royalty payments and the taxpayer does not use the product of the research in the taxpayer's trade or business."

Unlike product-specific R&D, energy conservation R&D may actually result in decreased use of the product that gas companies sell -- energy. Individual utility companies have less of an incentive under the current credit to invest in R&D to develop technologies that reduce consumers' costs or preserve the environment through greater energy efficiency because these technologies will lead to reduced sales for utility company.

It is in the public interest to encourage greater levels of environmental and energy efficiency research. Research that serves a public purpose usually requires a collaborative effort, rather than the commitment of a single company. These obstacles make it nearly impossible for an individual gas company to undertake public interest research.

It is possible that government-sponsored R&D may be curtailed as a result of efforts to cut government spending. Therefore, we must look towards more private sector, industry-based solutions to meet public needs. While the tax code is the only true private-sector incentive for R&D, its current requirements do not promote needed consortia research nor ensure adequate levels of energy R&D.

The purpose of the R&E credit is not just to promote R&E, but to promote technological innovations that will have a practical positive effect on our standard of living. In contemplating changes to the credit, the Subcommittee should, in addition to rewarding incremental individual research, seek to encourage companies to utilize their limited R&D dollars through collaboration. The discussion of this issue should be advanced beyond the perennial call to extend the credit; we should consider the best way to structure the credit to achieve its ultimate objectives.

The National Academy of Engineering has endorsed the concept of a collaborative R&E tax credit. Specifically, a recent Academy Study Commission looking at various measures to increase the level of stability of R&D through tax policy recommended:

> [that we] replace the current incremental Research and Experimentation tax credit with a permanent tax credit on the total annual R&D expenditure of a company to encourage an increase in the level and the stability of R&D activity across business cycles. In addition, extend the R&E tax credit to cover industry-sponsored R&D in universities, and other institutions, and the industrial contribution to R&D performed as a part of a consortium that includes government laboratories.

IV. Conclusion

We urge Congress to promote a domestic tax policy which fosters R&E conducted cooperatively. The collaborative R&E credit leverages research dollars while encouraging more efficient use of limited resources. The credit will encourage new research as it spreads risks and costs among consortia members. The credit will eliminate duplicative research that would otherwise be conducted at higher costs to individual companies.

The federal government must be as creative as industry in providing a fertile environment for the growth of R&E. It must recognize that other nations have not been complacent in expanding research opportunities, but have developed and nurtured a technology development and deployment infrastructure that is based on collaboration. We must begin immediately to take the steps needed to promote this environment in the United States. Encouraging research that would not otherwise be conducted is the primary justification for the R&E tax credit. Making a change that would enhance and encourage collaboration would greatly advance the underlying policy goals of current law. We urge Congress to extend the present credit and to include a modification to allow for a 20 percent credit for collaborative research.

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STATEMENT BY THE AMERICAN PETROLEUM INSTITUTE
FOR THE PRINTED RECORD OF THE MAY 10, 1995
HEARING
OF THE SUBCOMMITTEE ON OVERSIGHT
OF THE COMMITTEE ON WAYS AND MEANS,
U.S. HOUSE OF REPRESENTATIVES,
ON

EXPIRING TAX PROVISIONS,
INCLUDING THE RULES ON
THE ALLOCATION OF RESEARCH EXPENSES
UNDER THE INTERNAL REVENUE CODE OF 1986

The American Petroleum Institute (API) is a trade association of approximately 300 companies involved worldwide in all phases of the oil and gas industry, including exploration and production, transportation, refining and marketing, as well as petrochemical processing.

Because of the competitive significance and rising costs of research in an era of continuing growth of the foreign operations of its members as multi-national enterprises (MNEs), API welcomes the opportunity to submit its views on the importance of reasonable and reliable rules on allocation of the expenses of research and experimentation (R&E).

1. History of Rules Evidences an Awareness That Section 174 Must Not Be Diluted by Double Taxation, but Lack of Permanent Rule Instills a Chilling Uncertainty

The history of the rules on the allocation of the cost of R&E within the last 15 to 20 years reflects the awareness of the need of an allocation regime that respects the U.S. nexus of R&E and the need to avoid a frustration of the tax policy behind the R&E expense (R&EE) deduction under Code section 174. Unfortunately, the R&EE allocation rules have one of the most unstable histories of any Code provision; a brief summary will demonstrate this unfortunate aspect.

The first R&EE allocation rules under the 1954 Code were published in 1957 (T.D. 6258, 1957-2 C.B. 368). With the increasing focus on the sourcing rules as a consequence of the rising importance of the foreign tax credit, the U.S. Treasury Department (Treasury) proposed amendments in 1973 (38 F.R. 15,840[1973]), which after modifications in response to taxpayer comments led to Treas. Reg. section 1.861-8(e)(3)[the Basic Regulations]. The rules are complex and biased towards allocation of R&EE to foreign source income.

However, since 1981 these Basic Regulations have been

suspended and replaced by temporary favorable regimes no less than TEN times:

1) In ERTA 1981 Congress suspended the Basic Regulations for two years and directed 100% U.S. allocation (the Moratorium); the primary concern was that R&EE should not be allocated to income earned in a country that does not allow a deduction for the cost of research conducted in the U.S. Obviously, the disallowance of a deduction against both U.S. income and against the income in the host country will result in double taxation.

2) In response to a recommendation by Treasury, Congress extended the Moratorium (100% domestic allocation) by another 2 years in DEFRA 1984. Again, the rationale was that it was inappropriate to require allocation of U.S. R&EE to foreign source income, and that any loss of foreign tax credit would conflict with the tax policy underlying the section 174 deduction.

3) COBRA 1985 brought a one year extension of the Moratorium. At this point, three fragmented statutory "fixes" allowed taxpayers to allocate all R&EE incurred between August 1981 and August 1986 to U.S. source.

4) For taxable years beginning before August 1, 1987, the Tax Reform Act of 1986 continued with a more limited suspension of the Basic Regulations; the unqualified domestic allocation under the Basic Regulation was reduced to 50%.

5) After several failed Administration proposals of a pre-emptive (before application of the Basic Regulations) 67% U.S. allocation of U.S. R&EE, TAMRA 1988 finally approved a 64% domestic allocation, for the first four months of taxable years beginning after August 1, 1987.

6) OBRA 1989 revived the rule in Code section 864(f) for the first nine months of the first taxable year beginning after August 1, 1989.

7) OBRA 1990 again extended section 864(f).

8) A further "fix" is found in the Tax Extension Act of 1991 for the first six months of the first taxable year beginning after August 1, 1990.

9) The Internal Revenue Service (Service) published Rev. Proc. 92-56, 1992-2 C.B. 409, which allowed taxpayers to allocate according to section 864(f) for another 18 months. The Service acknowledged that the Basic Regulations may not reflect economic reality or good tax policy and promised a review of the allocation issue (which study finally was released on the 19th of this month, see below).

10) Most recently OBRA 93 revived section 864(f) for the first taxable year beginning on or before August 1, 1994, but reduced the automatic allocation to 50%.

With the expiration of the 1993 extension the rules of the Basic Regulation come to bear again. Since their promulgation 18 years ago, the Basic Regulations were suspended most of the time. This is a clear indication that the Basic Regulations are not perceived as a good rule. At the same time, the "on and off"

effect of the repeated extensions of the moratoria adversely affected the tax planning for research activities. The continuing threat of having domestic R&EE allocated to income earned in a country which does not allow a corresponding deduction and the ongoing exposure of a reduction of the foreign tax credit limitation have diluted or eliminated for MNEs the purported attractiveness of current deductibility of R&EE, representing a conflict in tax policy and sound tax administration.

On May 19, 1995 the Service promulgated a proposal to liberalize the Basic Regulations (Notice of Proposed Rulemaking, INTL 23-95). According to Prop. Treas. Reg. section 1.861-8(e)(3)(ii) the percentage of R&EE that may be exclusively apportioned to U.S. source income under the sales method would be increased from 30 percent to 50 percent. Concurrently Treasury issued its study "The Relationship Between U.S. Research and Development and Foreign Income" (the Treasury Study).

While the Treasury Study claims that the Basic Regulations "may be correct on average," it concedes that the 1977 rules "may be unfair to a significant number of taxpayers." Using 1990 data, the Treasury Study compared the allocation of R&EE incurred in the U.S. against foreign source under the Basic Regulations with past or proposed alternatives. The relative allocations under the expired OBRA 93 regime and the Proposed Regulations are 50% vs. 75% of the amount under the Basic Regulations.

2. **The Desirability of Keeping Research in the U.S. and the Effect on Competitiveness of U.S. Companies in the Global Market (Double Taxation) Recommend a Permanent Realistic and Equitable Allocation Rule**

Research is a vital factor in the economic growth of the United States. Particularly in a era of a lamented loss of manufacturing jobs to lower cost overseas production bases, a strong investment in technological development is an opportunity for the United States to maintain leadership in world trade and to assure the welfare of her people by securing challenging employment opportunities at home. Opportunities for research jobs will prevent the emigration of high skilled workers or, figuratively speaking, the waste of their talent in having to find employment in the proverbial fast food centers. The future of the quality of the U.S. labor force will depend to a great extent on the continuing investment in the creation of intellectual property and know-how in this country.

Thus, from the perspective of the nation's well being and economic strength, the promotion of domestic research is essential. We must remove any actual or perceived obstacles to making U.S. the primary choice of a MNE's research location. This includes the assurance of a deduction of R&EE incurred in the U.S. against other U.S. source income.

Under the Basic Regulations, MNEs with foreign source income obviously are denied to a great extent a deduction for U.S. tax purposes, although the research is physically carried on in the U.S., employing the talent of the U.S. job market and, more likely than not, the equipment and facilities from U.S. manufacturing output. Against this background of what one could view a U.S. tax penalty, MNEs may look to foreign countries which provide substantial incentives for locally conducted research.

Being under a pressure to maximize the marginal utility of each research dollar, the MNE may find itself having to move the research to the economically more hospitable (because of direct subsidies or tax breaks) foreign environments, reducing the opportunity of challenging U.S. research jobs and curtailing or eliminating the market for U.S. equipment and facilities.

Moreover, the allocation of U.S. R&EE deductions to foreign source income is flawed not only because it may lead to a migration of research activities to a more "hospitable" foreign country (which allows a favorable deduction or a direct subsidy, removing the double taxation exposure under the Basic Regulations), but also because the rationale of the R&EE deduction under Code § 174 obviously conflicts with the effective canceling out of that benefit as a result of the loss of foreign tax credits.

The current deductibility of R&EE under section 174 is an award for the risk taker, which serves as an encouragement as well as a means of providing a source for reinvestment in form of the cash flow from the deferral of tax on other income due to the current expensing of R&EE; the normal concern for matching income and expenses has no place in this context. This rationale must trump any effort to match a domestic deduction with arguable generated foreign source income. The general income/expense matching mandate does not apply here.

The repeated temporary legislative "fixes" of the ill conceived Basic Regulations must be turned into a permanent relief; domestic R&EE should always be allocated (at least predominantly) against U.S. source income. While the Proposed Regulations of May 19 are a step in the right direction, Treasury's own numbers indicate that still too much of domestic R&EE would be allocated to foreign source income, in disregard of the rationale behind the deduction under Code section 174.

STATEMENT FOR THE RECORD
CONCERNING THE TARGETED JOBS TAX CREDIT

BY:
Tzipporah Benavraham
Brooklyn, NY

Congressmen, policy makers, and members of the Oversight Subcommittee, I am pleased to address you this day regarding the issue of the Targeted Jobs Tax Credit Reauthorization, and the issues of how it has helped persons with physical disabilities find work. I am grateful you are affording me the opportunity to be heard and hope that you will weigh my comments well and keep this very important law in effect for the physically disabled who desire the opportunity to work.

I am well aware of the talk concerning the issues of welfare reform and the unfunded mandates. I know that there are any problems this country has faced with an economy that looms hard on the next generation and on issues of budget. However, government and public policy has always looked for ways to protect those who cannot help themselves as there is a recognition that we are our brother's keeper and have a heartfelt and moral pledge to show compassion to those less fortunate. There have been grave errors in public policy over the years. However, many times there are answers formulated by policy makers to help the populations they intend to serve.

I myself suffer from a painful and degenerating disease called multiple sclerosis. I am legally blind, use a wheelchair, and a ventilator. However, by the good graces of a society that is aware of the needs of the poor and sick, we have established ways that I received rehabilitation, obtained medical equipment, and most noteworthy, I received an advanced education. With my graduate degrees, I sought to become an educator of disabled technology. I run a small laboratory at three colleges in New York City teaching disability technology since 1986. By the good graces of the National Science Foundation Handicapped Assistance Facilitation Award in 1991, I lectured and published concerning the access disABLED persons have to the emerging technologies. And proudly I mention that of the 870 students I have taught since 1986, I have over 200 who are disabled and graduates of my education processes. I also have the grace of being on the Board of Directors of the People to People Committee on Disability since 1992, which was established by President Dwight D. Eisenhower in 1956 as an international outreach on disability information to other nations.

However, recently my part time profession of being an adult and college educator has been curtailed dramatically in New York. It occurred to me since I am well published but credentialed, I should seek out ways that I can ply my craft and share my knowledge with others. Since I am blind, I went to the New York State Commission for the Blind and obtained in February the Targeted Jobs Tax Credit forms from the senior counselor and went with these to the Labor Department handicapped counselor to seek out another college in the city where I might find work. You see, I would need to have ramps, an accessible bathroom, adaptive technology and a few costly accommodations on any job site. Where I am now, as a part-timer, I have no medical insurance because I am both part time and also have a pretty severe pre-existing condition for insurance purposes. The extra amount of money it takes to hire a person like me is a serious issue to any potential employer if they do not already have these accommodations in place, or if they have no cash upfront to pay for the accommodations I need. The Americans with Disabilities Act is wheat your Congress considers an "unfunded mandate". yet this provision of the Targeted Jobs Tax Credit

can often cover the cash needed that an employer may NOT have to retrofit and hire someone of my qualifications. They may weigh heave whether or not there is money for these accommodations if there were no way to "sweeten the deal" so to speak by having a tax credit and incentive up front to justify the process of proceeding with the interview. Here with the TJTC, as well as section 190 of the IRS code which allows for retrofits for the handicapped access accommodations, as well as section 44 of the IRS code, allow for the most broad funding of the provisions that my life easier in a job hunt.

By the good graces of this country, which has the best educational system in the world, I have achieved the status of being "qualified" for a job DESPITE my physical limits. However, the "leg up" needed is clearly in the incentives a person would have to hiring someone with my qualifications. I studied the emerging technologies in hopes that I wold find a way to incorporate the disabled into them as they progressed. And with the hope in hand, I worked with the National Science Foundation's handicapped coordinator, Dr. Larry Scadden, and the luminaries of our time in this realm, such as Dr. Greg Vanderheiden, Dr. Norman Coombs, and Dr. Gary Woodill. I gleaned and interacted in hopes of finding employment in this realm, and obtained many credentials to help me fulfill this goal.

But I wold like to impart to you how the LACK of this law being currently in effect has HURT my job hunt. There is a college in New York City which was looking for a handicapped student coordinator. It is well known for its technology training and education. The labor department referred me to this college. However, there is NO handicapped bathroom ON CAMPUS, no adaptive technology, and the concern also was that with my disability of multiple sclerosis, that their insurance premiums would rise to cover my needs. It was a referral to a full time position. There was an extreme reluctance when they noted this provision of TJTC had NOT been in effect at the time of the interview. In that I was told I would be "considered" for the job BUT there was economic factors which would have FIRST have to be dealt with.

In yet another job interview with a Fortune 500 company, I was clearly the most qualified person. It was a major company wanting to make their publications available for the disabled online as a new commercial enterprise. They needed a person proficient in disability access issues to online materials as well as someone who knew the machinery of the online productions. I invite all here in this hearing to look at my internet project and site of the St. John's University Electronic Rehabilitation Resource Center at gopher. sjuvm.stjohns.edu. I and my students placed over 485 megabytes of materials on disabilities online on the internet since 1989 when it began for free. The employer who I interviewed with was clearly impressed and said he never saw anything else like it. However, the issue of insurance and my own personal needs for adaptive equipment was an issue since he asked about costs and clearly had some degree of consternation about the figures he came up with. However, with section 44 of the IRS code AND Targeted Jobs Tax Credit (if it had been in effect at the time of the interview) as well as this large business being able to also use the section 190 of the IRS code (which it could not at this time since it made over one million dollars a year in gross receipts), I MIGHT have been able to obtain this $75,000 a year job. The lack of any incentive or fund to pay for those accommodations made ME a LESS desirable candidate for the position DESPITE what the interviewer said were superior credentials. It seemed they lacked a budget for an employee who may need accommodations to do the job. In that, the lack of that credit or provision made me lose the position to another person. And my frustration was great.

Congressman, I WANT to work. I WANT to be able to find a barrier-free environment both to live and work in. I HAVE worked, albeit part time. However, I HATE having to by no choice of my own sit on Supplemental Security Income (SSI) and NOT work, when I have the ability to work IF barriers are eliminated.

I would hope that technology can be part and parcel of the new avenues to dignity for disabled persons. However, the power of the incentives in labor laws and tax laws can help us fund our own ways to independence. Without a national health care system, the physically disable are relegated to poverty and a trap-like situation. We have scarce options to get out of the cycle of dependence. I encourage your committee to consider the reestablishment of the provisions of this law: the Targeted Jobs Tax Credit.

I would also seek that Congress establish a way that in tax law and in labor law allow for the accoutrements for technology access for persons with disabilities as well as for other incentives. It would be a fine idea to extend and help businesses use the section 190 and section 44 sections of the IRS code to hire more people with disabilities. With a reauthorization of the TJTC, Congress might consider a special category of incentive for hiring people who are handicapped for the employers.

It would bode well to help the disabled become equals in the new developments for the new information technologies. I think giving industry an incentive to have certain disability access in their hardwares and softwares off the shelf may also be a good idea. The initiatives of Dr. Larry Scadden of the National Science Foundation in the topic of Universal Design may well be a keystone and marker for Congress to give an incentive to industry to develop. Built in large print and voice synthesis, as well as alternate keyboard configurations may be worth supporting in the information technology industry of the future. Home-based computer businesses are rising. It would be a good idea to help include the disabled in the plans for the new information industries as we progress in our newer industry developments.

Thank you for letting me address you today at this hearing. I am hoping these ideas will bear weight in your deliberations and that I gave you serious points to ponder. I am hoping I have mirrored a real concern to preserve these special tax credits and help the disabled better help themselves. Thank you.

Hearing before the
Subcommittee on Oversight
Committee on Ways and Means
U. S. House of Representatives

on

Allocation of Research Expenses

May 10, 1995

Written Statement
of
William F. Ausfahl, Chief Financial Officer
The Clorox Company

The Clorox Company appreciates the opportunity to submit this written statement concerning the need for a permanent set of rules governing the allocation of research and experimentation (R&E) expenses. Clorox is the leading U. S. manufacturer of home cleaning products and liquid bleach. These products include Pine-Sol, Soft Scrub, Formula 409, and Clorox liquid bleach. These and many other household products are sold in more than 90 countries worldwide.

Clorox strongly believes that a permanent solution to the rules governing the allocation of R&E expenses is needed and that these rules should not be a disincentive to conducting research in the United States. It is essential that the Congress and the President provide certainty in this area of the tax code, which is of vital importance to the competitive position of U. S. multinationals and to maintaining the U. S. job base.

R&E allocation regulations under Treasury Reg. Sec. 1.861-8(e)(3), issued in 1977, generally provide that taxpayers may automatically allocate 30 percent of research performed in the United States against U. S.-source income. The interplay of these rules with the foreign tax credit can increase the cost of performing research in the United States. Congress on nine occasions has overridden the application of the 1977 regulations because of concerns that the 1977 regulations would encourage U. S. multinational businesses to shift research activities abroad.

Clorox applauds the action taken by Congress most recently--as part of the Omnibus Budget Reconciliation Act of 1993--to suspend application of the 1977 regulations. The rules under the 1993 Act, which provided for a more favorable 50 percent automatic allocation, expired at the end of 1994 for calendar-year taxpayers. Clorox believes permanent rules, statutory or regulatory, should quickly be implemented which provide for at least a 50 percent automatic allocation of U. S.-based research to U. S.-source income.

Research and development is a cornerstone of a growing economy. This is attested to by the significant incentives to attract research activities that have been enacted in recent years by numerous other countries. In the United States, the importance of research is reflected in part by the section 41 tax credit for increasing R&E expenditures, which enjoys strong support from lawmakers of both sides of the aisle and the Clinton Administration. U. S. rules for allocating R&E expenses should work hand in hand with the research credit to help the United States compete in an increasingly global economy.

Action on the R&E allocation rules needs to be taken this year--either through legislation or regulations--that recognizes the importance of U. S.-based research activities. Otherwise, taxpayers will be left with the 1977 regulations and their detrimental impact on the U. S. economy. It also is important that policymakers settle on a permanent solution, which would end 18 years of complexity, confusion, and controversy in this area.

Statement for the Record of
David O. Webb, Senior Vice President
Policy and Regulatory Affairs
Gas Research Institute

for R&E Tax Credit Hearing

May 10, 1995

Gas Research Institute (GRI) appreciates the opportunity to provide testimony for the Record relating to the Research and Experimentation (R&E) tax credit. We believe research and development (R&D) is the lifeblood of improvement in products, processes, efficiency, and productivity. The current R&E tax credit should continue and should be extended permanently. Annual extensions or extensions for only a few years at a time do not provide a stable base for planning and conducting research, especially long-term research that may require five to ten years to complete.

The current tax credit has not inspired the level of R&D which we as a nation must promote to keep pace with an ever increasing competitive world market and the need for collaborative R&D. Therefore, we urge consideration be given to the proposed modification of the existing law to provide for an optional 20% flat credit for contributions to research that is done collaboratively. Collaborative research is normally performed for the public's benefit by not-for-profit scientific and educational organizations. This would serve as an important incentive for the private sector to increase its commitment to collaborative research.

GRI is a not-for-profit 501(c)(3) organization established by the gas industry to conduct broad collaborative research and development programs for the industries, their customers and society.

GRI was founded in 1976 by a Committee of members of the boards of directors of the American Gas Association (A.G.A) and the Interstate Natural Gas Association of America (INGAA). Consequently, GRI is the research, development and demonstration (RD&D) management organization of the natural gas industry. Its mission is to discover, develop and deploy technologies and information that measurably benefit gas customers and enhance the value of gas energy service. GRI accomplishes its mission by planning and managing a consumer sensitive, cooperative research program emphasizing technology transfer. GRI conducts its R&D program in cooperation with its member companies and other participants, who provide funding as well as input for the programs content and direction.

GRI is funded by a surcharge collected by its 37 interstate pipeline member companies through tariffs approved by the Federal Energy Regulatory Commission (FERC) for natural gas transportation services. Regulatory bodies in the 50 states and the District of Columbia are automatic intervenors in the FERC review of GRI's programs. GRI's 326 members include natural gas interstate pipeline companies, natural gas producers, investor-owned distribution companies and municipal gas utilities. Membership in GRI is totally voluntary.

When the current R&E tax credit measure was written it was intended to address the kinds of research that is conducted by organizations such as GRI, i.e., the technologies themselves. However, as written, it does not adequately address research conducted by collaborative organizations. Because of this discrepancy, the R&E tax credit is being restricted in ways never contemplated by Congress, and indeed, is inconsistent with Congress' express intent. In addition, restrictions are often placed on the remainder of the contribution because of questions relating to the "carrying on any trade or business requirement" and the transfer of the research results to another entity in return for license or royalty fees under the current law. As an example, GRI conducts research on the more efficient use of natural gas in home furnaces, industrial processes and commercial cooling. However, since this research does not have an absolute direct link to the pipeline's business, the IRS has determined that the current law does not allow this research to

qualify for the tax credit. These unresolved issues present a major disincentive for collaborative research contributions.

Although the current law has been somewhat useful in stimulating R&E conducted by firms at their own research facilities, the law fails to encourage collaborative R&E conducted by consortia. Typically, consortium members pool their funds and contract with a third-party research organization that carries out the actual research. The current law reduces the tax credit by one-third by limiting the credit to 65 percent of the full value of this type of research (i.e., research that is contracted out) compared with the tax credit for research conducted in-house. Thus the current law does not provide as much of an incentive for consortia-based R&E as it does for R&E conducted by individual firms at their own research facilities.

Collaborative research has many advantages over individual research. Primarily it pools limited R&D dollars. Additionally, collaborative research can bring together all entities needed to research, develop, and market the results often more quickly and efficiently than a single entity. And, finally, collaborative research diminishes the chance for duplicative research which wastes valuable research dollars. Attached are types of successful collaborative research which has been carried out by members of GRI.

It is in our national interest to correct the inequity between the tax credit for in-house research versus consortia-based research. Consortia-based R&E can be very effective in reducing overhead costs and in assuring that research results are quickly made available to a broad industry segment. Equally important, much of the research conducted collaboratively by consortia, such as collaborative research conducted by the energy industry, involves technology to use a product more efficiently. Collaborative, consortia-based research often is research that would not otherwise be conducted because it is too costly, too risky, or too long term to undertake individually. While this type of research is of great value to the consumer and to our nation, it does not necessarily result in increased sales or profits to individual organizations, and therefore, will not be a priority.

One proposal for improving the credit is to modify the credit to reward contributions to research that is conducted collaboratively -- research conducted by teams of companies or utilities through a 501(c)(3) scientific research organization like GRI or Electric Power Research Institute (EPRI).

A flat 20 percent tax credit will provide contributing firms a significantly greater incentive on a comparative basis than the current credit. Such a modification will complement rather than interfere with existing law, would not have major revenue implications, and will improve the credit in several ways. In the words of former Treasury Secretary Bentsen, such a modification "can significantly improve the efficiency and effectiveness of the R&E tax credit." By encouraging collaboration the credit would:

- Encourage research that would not otherwise be conducted to be done in the most efficient manner by eliminating duplicative R&D on matters of wide public policy importance and interest to the firms (such as energy efficiency, environmental, or manufacturing process R&D). The credit will therefore assist in rewarding firms least able to recapture -- and who may never recapture -- their expenditures.

- By reducing redundant R&D, a collaborative modification will save increasingly limited private funds that can be devoted to R&D, and it will also save public funds by improving the efficiency of the tax credit itself by encouraging firms to take the collaborative R&E tax credit when they pool their research efforts.

- Most importantly, a collaborative credit modification will advance the main underlying policy goal of the existing credit most effectively by encouraging new R&D. That is because "incentivizing" collaboration will either encourage more efficient R&D or will encourage new research by spreading costs and risks.

- By encouraging collaboration, the credit would help speed discovery of innovations by pooling experiences of firms, and it will encourage speedy deployment of R&D results

to a broad base of parties. Part of the reason for the accelerated deployment is that consortia typically involve both users and consumers of technology.

The proposed modification is as timely as it is relevant. As Congress looks for ways to reduce the federal budget, federal R&D is a function often targeted for major spending reductions. In view of the proposed federal budget cuts for R&E, the tax credit modification is a means of promoting R&E for the public benefit funded by the private sector. With the proposed elimination of federal programs and significant cutbacks in funding for energy R&E, federal research programs inevitably will be reduced in size. Unfortunately, many of the critical gaps in these research programs, such as research on energy and the environment and improvement in efficiency, will not be filled by the for-profit private sector. Such research activities are often the last conducted by the private sector because these research dollars are the most difficult to recapture in sales over the short term. In the case of the regulated natural gas industry and the electric utility industry, these expenditures often cannot be completely recaptured through the rate base.

As Congress reduces federal spending for research, encouraging collaborative research through the proposed modification to the R&E tax credit will provide the means to speed the transition to more private sector research in a cost-effective manner. Moreover, the proposal will fill the research gap by privatizing decisions about the scope and nature of such research.

I respectfully ask for your serious consideration and support to extend the current R&E tax credit and to modify it to provide a flat 20 percent credit for collaborative R&E conducted through not-for-profit 501(c)(3) scientific research consortia. As Congress takes steps to reduce the size of the federal government and corresponding federal funding for research, your support for an R&E tax credit that encourages collaborative, consortia-based research in even more crucial.

DOT Approves Using Clock Spring

The natural gas industry has received permission from the U.S. Department of Transportation to use Clock Spring®, an advanced pipeline-repair technology developed through the sponsorship of the Gas Research Institute.

A waiver filed with the Federal Register by the DOT's Research and Special Programs Administration is expected to significantly expand the use of the technology and provide pipeline companies with a new opportunity for reducing maintenance costs.

The waiver to DOT Rule 49 CFR 192.713(a) was granted in response to a petition from 28 gas pipeline operators, including Texas Gas, on behalf of the pipelines by the Interstate Natural Gas Association of America in November 1993. The waiver, which is subject to conditions and future performance evaluations, allows pipeline companies to use Clock Spring technology as an alternative to more costly pipeline repair methods. Previously, the regulations set by DOT, the governing agent for pipeline repairs, called for two methods for the repair of gouged, dented or corroded pipe — covering the damaged pipe with a welded metal split sleeve, or temporarily removing the pipe from service and replacing the damaged section.

Clock Spring offers significant advantages over previously mandated repair methods. Labor and material savings using Clock Spring have been estimated at up to 40 percent over the metal sleeve repair method and 65 percent over section replacement. Based on pipeline industry input on the expected use of Clock Spring, GRI estimates an annual industry savings of $8.5 million to $11.5 million.

Developed by NCF Industries Inc., and Clock Spring Company LP, with support from GRI and Panhandle Eastern Corporation, the Clock Spring repair system consists of a fiberglass composite-reinforced coil that is wrapped around a pipe defect with a specially designed adhesive. Initially marketed as a crack arrestor in 1987, product development, proven in laboratory and field validations, has since advanced the technology to its current status as an option for the repair of pipe gouges, corrosion and other anomalies. Repairs made with Clock Spring have shown the capability to restore the strength of the line pipe sufficient to permit it to operate at its original allowable operating pressure. As part of a demonstration program by the Gas Research Institute, the Clock Spring has been installed on a number of pipelines nationwide including on two segments of Texas Gas' No. 1 26-inch diameter line near Grand Rivers, Ky., and Clarksdale, Miss.

"The value of this technology has been proven in extensive field evaluations," explains Theodore L. Wilke, GRI vice president, gas operations technology development. "With the Clock Spring system, permanent repairs can be made while the pipeline is operating. This enables pipelines to avoid customer-service interruptions, as well as revenue and vented gas losses. As shown by the number of companies joining the petition filed with DOT, the industry has long recognized the benefits of using Clock Spring. However, until now, regulations have not permitted its use on gas pipelines."

Clock Spring is manufactured and marketed by Clock Spring Company (Houston). The composite material used in the Clock Spring system consists of glass fibers impregnated by a resin matrix. Fiberglass is highly resistant to corrosion, and fiber-reinforced composites are known for their high strength, light weight and relatively low cost.

Application of the composite repair material is a fairly simple process. Once the pipe defect has been inspected, prepared, and filled, a coiled band of Clock Spring material is wrapped around the pipe and bonded into a single unit with a proprietary adhesive. This repair method not only restores the pipe's original pressure capabilities, but can also improve its resistance to further structural deterioration.

INFIELD RESERVE GROWTH

Geology Combines with Geophysics, Engineering, and Petrophysics to Reveal New Reserves in Old Fields

The lower 48 states contain approximately 800 trillion cubic feet (Tcf) of technically recoverable natural gas in reservoirs of conventional "tightness" (porosity and permeability). Of this, approximately 400 Tcf is in undiscovered fields, and about 160 Tcf is proved reserves. The remaining 240 Tcf, however, is incremental gas left behind in existing gas fields (in uncontacted or incompletely drained compartments). Today, technological improvements and changes in the economics of development make these "left-behind" resources both attainable and highly attractive.

"By taking a multidisciplinary team approach that brings together the expertise of geologists, geophysicists, petrophysicists, and reservoir engineers, you can achieve a more complete characterization of complex, heterogeneous reservoirs, and, with greater precision, target the placement of new wells and recompletions in existing wells."

L. Frank Pitts
President
Pitts Energy Group

Over the last six years, GRI—with the U.S. Department of Energy (DOE), the Bureau of Economic Geology (BEG), and the state of Texas—has developed advanced techniques for identifying missed gas in mature fields.

This program, entitled "Infield Natural Gas Reserve Growth Joint Venture," is reevaluating older fields in the Gulf Coast and Midcontinent regions. The result is significant new reserves at costs far less than full-cycle exploration and production operations. Since June 1993, the program has been concentrating on the Boonsville field, near Fort Worth, TX.

conventional approach. A well was drilled based on these combined data, however, and the initial results were good.

"By taking a multidisciplinary team approach that brings together the expertise of geologists, geophysicists, petrophysicists, and reservoir engineers, you can achieve a more complete characterization of complex, heterogeneous reservoirs, and, with greater precision, target the placement of new wells and recompletions in existing wells," explains L. Frank Pitts, President of Pitts Energy Group.

The major benefit of the Joint Venture program is that even small operators can use its techniques to redevelop fields and exploit reserve growth opportunities, at costs and risk factors much lower than traditional exploration and production procedures. A field test in Victoria County, TX, demonstrates the economic advantages of secondary gas recovery. Costs for redeveloping several targeted reservoirs were $0.31 per thousand cubic feet (Mcf), while the market price for the gas was about $2.00/Mcf.

In the Gulf Coast region, reserve additions per gas development well were up 48 percent in 1993 compared to the 1991-92 average, and were the second highest in 14 years. In addition, costs were reduced substantially.

Although field experiments are still underway to identify absolute links between structure, sequence stratigraphy, and the distribution of reservoir compartments, much has been accomplished. "You must understand the geological environment of your property and do your homework in all disciplines to be sure that you are able to make a rational analysis," conclude Gary Hoge and Tom Coffman, Coffman Exploration, Austin, TX.

House of Representatives
Committee on Ways & Means

Subcommittee on Oversight

Hearings
on the
Research and Experimentation Tax Credit

May 10, 1995

Statement for the Record
by
Joe Cobb
John M. Olin Senior Fellow in Political Economy
The Heritage Foundation
Washington, DC 20002

We appreciate very much the opportunity to include a statement in the hearing record on the way in which our government treats both the taxation of private research and experimentation, and the Clinton Administration's apparent preference for a "Big Government" approach.

We can all agree that the United States, as the leading economic power in the world, is challenged continually on the frontiers of new technologies to stay in the lead. But there are two very distinct philosophies about how to make the needed progress.

Some people advocate government leadership, government planning, and government investment. We say that is wrong. Progress and innovation do not come from direct government aid, but from the efforts of inventors and scientists and engineers in the private sector. Even government funded laboratories and universities make the discoveries they do at the computer terminals and laboratory facilities where the scientific personnel themselves have wide freedom of action, independently of the program planners in their administrative offices.

To remain the world's leader in science and technology, the United States must put more emphasis on letting the private sector take the lead and ***reduce emphasis on government programs*** as the main strategy. The Clinton administration has clearly taken a stand in favor of government action.

Statement of Joe Cobb
The Heritage Foundation

The Disappearing R&E Tax Credit

The research and experimentation (R&E) tax credit expires on June 30, 1995. Last year the Clinton Administration did not support its extension. This year, their "support" is tucked away in a little note in the tax section of their budget, and it is not even mentioned in the Research and Development discussion.

It is clear that the R&E tax credit is quite peripheral to the Administration's science and technology policy goals. In our opinion, by contrast, that is where the main emphasis ought to be placed.

Instead of exploring new and sound ways to promote private industry research and development (R&D) or even private-public partnerships, the Clinton Administration has chosen to increase federal funding of government chosen research. As the following table shows, the Administration's record shows federal civilian R&D spending will have grown 15.1 percent by 1996, although defense-related R&D spending has fallen 9.9 percent.

CLINTON ADMINISTRATION'S R&D SPENDING

Dollars in millions	1993	1995 (est.)	1996 (prop.)	1993-96	1995-96
NASA	$8,885	$9,561	$9,179	3.3%	-4.0%
Commerce Dept.	607	904	1,096	80.6%	21.2%
EPA	519	552	616	18.7%	11.6%
ATP	68	431	491	622.1%	13.9%
TRP	472	443	500	5.9%	12.9%
Mfg. Extension Prog..	18	91	147	716.7%	61.5%
HHS	9,666	11,272	11,793	22.0%	4.6%
Total Civilian	30,329	33,815	34,902	15.1%	3.2%
Total Defense	42,164	38,898	37,981	-9.9%	-2.4%
Total All	72,493	72,713	72,883	0.5%	0.2%

Source: *FY1996 Budget of the U.S. Government*, pp. 94-95; and *Analytical Perspectives*, p. 119.

More noticeably, a series of programs of widely questioned effectiveness have grown dramatically. From Fiscal Year 1993 through Fiscal Year 1996:

- ✓ the Advanced Technology Program (ATP) would grow to $491 million, or 622 percent
- ✓ the Technology Reinvestment Program (TRP) would grow to $500 million, or 5.9 percent
- ✓ Commerce Department R&D would grow to $1.1 billion, or 80.6 percent

- ✓ the Manufacturing Extension Partnership would grow to $147 million, or 717 percent
- ✓ HHS Department R&D would grow to $11.8 billion or 22 percent.

The Unwelcome New System of Government Tech Centers

The Manufacturing Extension Partnership (MEP) program is a prime example of the Clinton Administration's bold new government-dominated initiatives. But at the same time, it is a good example of why this approach needs to be questioned.

Started in 1988 as part of the Omnibus Trade and Competitiveness Act, the MEP was supposed to bridge the gap between sources of manufacturing technology and the small and mid-sized companies that were viewed as facing barriers that make them relatively slow in adopting important new technologies. The National Institutes of Standards and Technology (NIST) is in charge of the initiative.

The NIST program has been criticized as unworkable and unresponsive to industry needs. In a 1991 report, the General Accounting Office indicated that "overall, the ... programs have been only somewhat effective in addressing the technology needs of small manufacturers ... while legislation establishing the ... program emphasized the transfer of advanced technologies being developed at federal laboratories, the centers have found their clients primarily needed proven technologies."

Mandate for Change, the political issues handbook published by the Progressive Policy Institute (PPI) in January, 1993, which in those days was called "President Clinton's think tank," criticized the MEP tech centers as:

> their performance has been disappointing. Like other government retail service efforts, the extension services have reached too few firms and most manufacturers regard them as unlikely sources of practical expertise. [p. 75]

The book advocated instead a new kind of privately run "teaching factory," which [emphasis supplied]:

> would overcome many of these extension services shortcomings by operating as an *industry-owned and -operated* learning center. It would offer groups of firms within a particular industry a place to put new processes into

> operation and experiment with new technical applications. Its relevance to real factory floor problems would be reinforced by a *requirement that firms provide at least half the operating costs of the facility. [ibid.]*

Private industry-led alternatives to the government extension centers exist — from networks of consultants to full-scale integrated teaching factories. These alternatives address the concern raised by the Progressive Policy Institute's study, yet the Clinton Administration has increased MEP funding to $147 million, which is 717 percent.

Vanished? A Collaborative Private Sector R&E Credit

More important, however, is that the Clinton Administration's budget completely ignores two initiatives to foster what are truly industry-led partnerships — a modification to the existing R&E tax credit introduced in the previous Congress by Senators Danforth and Baucus (S. 666) and Senator Lieberman (S. 394) to reward collaborative R&D. Incentives for collaborative R&D have wide support, including the Democratic Leadership Council, the NorthEast-MidWest Coalition, the National Academy of Engineering and others.

These proposals would modify the R&E tax credit in a fiscally responsible way. By providing a greater reward in the form of a flat credit for R&D conducted in teams from different organizations, the modification would maximize limited private and public sector R&D and encourage firms to allocate scarce R&D resources to projects that benefit both their individual goals and joint, industry-wide goals.

The proposed extension of the R&D tax credit would also stimulate new research — research unlikely to be undertaken individually whenever it might be too risky or too long-term, or so generally applicable that no single developer could fully capture all the benefits competitively. By making more efficient use of both private and publicly funded R&D resources, the proposed collaborative credit could significantly advance the overall efficiency and effectiveness of the R&E tax credit.

Today one of the most touted reasons for government initiative R&D financing is that a central agency has some advantage in selecting among different proposals submitted by individual organizations and companies. Therefore, and perhaps most importantly, a collaborative R&E tax credit would allow private industry to initiate joint research and experimentation projects. *Private*-public partnerships would be

encouraged to flourish without the obtrusive hand of the federal government directing the area of study.

The cost of stimulating industry-led partnerships would be significantly lower through a collaborative R&E tax credit than through direct federal subsidies. The Danforth-Baucus and Lieberman modification in the R&E tax credit was estimated to cost about one-quarter the amount of the existing R&E tax credit. This would be roughly one-half of the cost of the ATP program — a program that has been criticized as one "unblemished with success."

The Congress needs to adopt policies that promote private industry-led R&D rather than government-led R&D. Congress should protect incentives for the more efficient, collaborative form of R&D employed to a greater degree by our trading partners. And Congress should ensure that industry puts its money where its self-interest is, that the private sector co-funds the research. This would most effectively assure and that the research is relevant to the practical needs of America's manufacturing industries. A collaborative R&E tax credit provision, like the proposals introduced in the previous Congress by Senators Danforth and Baucus (S. 666) and Senator Lieberman (S. 394) should be given serious consideration by this Committee.

STATEMENT ON THE RESEARCH AND EXPERIMENTATION EXPENSE ALLOCATION RULES AND THE RESEARCH AND EXPERIMENTATION TAX CREDIT

BY THE
NATIONAL ASSOCIATION OF MANUFACTURERS

FOR SUBMISSION TO THE
SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

MAY 24, 1995

Introduction

The National Association of Manufacturers (NAM) is a voluntary business association of more than 13,000 firms located in every state. Our members range in size from the very large to the more than 8,000 small members that have fewer than 500 employees. The NAM's member companies produce more than 80 percent of the nation's manufactured goods.

The NAM submits this statement for the printed record of the May 10, 1995, hearing regarding the research and experimentation expense allocation rules, commonly known as the "861 R&D allocation regulations," and the research and experimentation tax credit, commonly known as the "R&E tax credit."

RESEARCH AND EXPERIMENTATION EXPENSE ALLOCATION RULES

These regulations are a prime example of how the current federal tax regime places U.S. multinational firms at a clear competitive disadvantage in the international marketplace. The NAM strongly recommends that the Congress work with the Administration to ensure that a permanent regulatory solution to the R&E expense allocation issue is adopted this year, and to enact corrective legislation if such relief is not promptly forthcoming. A final resolution of this problem is crucial to the international competitiveness of U.S. manufacturing.

In 1977, the Treasury adopted onerous regulations under Internal Revenue Code Section 861 continuing specific rules requiring allocation of the expenses of R&E conducted in the U.S. between a taxpayer's U.S. source and foreign source income. Although the Section 861 R&E allocation rules operate through the mechanism of the foreign tax credit limitation, their practical effect is the same as denying an income tax deduction against U.S. income for part of the R&E actually conducted in the U.S.

Needless to say, the foreign countries to which U.S.-conducted R&E expense is allocated do not allow U.S. firms a deduction for such allocated expense in computing foreign taxes owed. U.S. multinational firms are thus penalized for conducting all or a substantial portion of their R&E in the U.S., giving rise to a strong incentive to move part of such R&E overseas. In our view, this is not only unfair but constitutes singularly poor public policy. It is significant to note that we are the only major industrialized nation that does not allow domestic taxpayers to fully deduct domestic R&E expenses against domestic income.

Since adoption of the 861 R&E regulations in 1977, Congress and the Administration have advocated and adopted a number of temporary moratoria to prevent the full implementation of the rules. Under the latest moratorium, included in the Omnibus Budget Reconciliation Act of 1993 ("OBRA '93), 50 percent of domestic R&E expense was allocated

and apportioned to U.S. source income, with the remaining 50 percent allocable between U.S. and foreign source income on the basis of sales or gross income. The OBRA '93 moratorium expired December 31, 1994, for calendar year taxpayers. Therefore, the 1977 regulations must be applied for future years unless a regulatory or legislative solution is adopted.

The NAM believes that a permanent resolution to the 861 allocation regulations issue is long overdue, and requests that you work with the Administration to ensure that such a solution is promptly adopted through regulations. Otherwise, Congress should pass corrective legislation this year.

Domestic R&E is Crucial to Competitiveness of U.S. Manufacturers

The NAM believes that providing stable tax treatment for R&E that does not discourage U.S.-based R&E is crucial to the international competitiveness of U.S. manufacturing. Numerous econometric studies have demonstrated a positive link between R&E spending and increased productivity, which in turn leads to increased U.S. competitiveness and GDP growth. The vast majority of private (i.e., nongovernmental) R&E outlays are made by manufacturing firms. To the extent this R&E leads to increased productivity in the manufacture of goods, such goods become more competitive in both domestic and overseas markets. The international aspect of this improved competitiveness is especially important, since in recent years, the growth in manufactured exports has been the main source of strength in the U.S. economy.

Accordingly, the NAM believes the case for regulatory or legislative resolution of the R&E allocation issue is extremely strong. Equally strong, in our view, is the need to make such resolution permanent. R&E by its nature is often a long-term proposition. Indeed, it is not unusual for half of a firm's R&E to be directed at projects with a time horizon of five to ten years. Manufacturing concerns need the stability that is necessary for sound, long-term business planning.

Recommendation

The NAM strongly supports a definitive resolution to the R&E expense allocation regulations issue this year. We appreciate the opportunity to submit this statement and would welcome the opportunity to work with Congress and the Administration to resolve this longstanding problem.

RESEARCH AND EXPERIMENTATION TAX CREDIT

Cost of Capital Considerations

The most critical economic determinant on the manufacturing sector of the United States economy is the cost of capital. In recent years the cost of capital for United States manufacturers, both in absolute terms and relative to manufacturers in other countries, has experienced an unfavorable trend. Increased cost of capital adversely affects our ability to maintain a skilled workforce, price goods competitively in the global market and develop technological innovation.

Research and Experimentation Tax Credit

In legislation the U.S. House of Representatives passed this year, it has begun to address cost of capital issues on a broad scale. It has taken measures to enhance the recovery of investment in plant and facilities, it has passed moderation in the taxation of capital gains, and has provided a savings vehicle which will serve to encourage U.S. savings. And there are signs that out-of-control regulation will also abate. All of these have a favorable impact on cost of capital and enable our members to make even greater

contributions to the well-being of our citizens.

Yet there remains attention to the single most important capital element in maintaining world technological leadership. The capital flow created by the research and experimentation tax credit must be maintained.

Productivity of the Manufacturing Sector

Manufacturing productivity growth averaged almost 3% during the 1980s and early 1990s, nearly three times as high as in the non-farm business sector. When measured in terms of output per unit of labor and capital, it is six times greater. This broader measure, total factor productivity, mainly reflects technological advance.

The United States has continued to maintain a higher average level of manufacturing productivity than any of the large industrial countries. According to a recent study at the Brookings Institution, productivity in German manufacturing stood at 86% of that in the United States compared with Japan at 78 percent. Individual worker productivity statistics demonstrate similar United States leadership.

United States companies are far ahead in the deployment of information technologies. The number of personal computers in use in the workforce in this country is more than twice the number in use in Germany and nearly four times the personal computers in the workforce in Japan. Besides the huge lead in use of personal computers, some 56% of U.S. personal computers can communicate with other computers within a company through local area network connections, compared with just 13% in Japan. Eight of the top ten personal computer companies worldwide in 1993 were American. The U.S. lead in information technologies has contributed to export growth, thereby strengthening U.S. manufacturers' global competitive standing.

From the start of the export boom in 1986, the number of export jobs related to export goods increased by more than 2.3 million. Every year since 1986, the number of jobs supported by goods exports have been more than double the number supported by service exports. Each $1 billion of new exports creates an average of 17,000 new jobs.

Over the period 1970-1993, 68% of total United States R&D was performed in industry. Ninety percent of all industrial R&D is conducted by manufacturers. The relationship is obvious -- R&D activity by manufacturing businesses in the United States has contributed significantly to the country's continuing leadership among the worlds leading countries. The Research and Experimentation Tax Credit works. It is effective; it is productive; it creates jobs. It needs to be extended and made permanent.

Fundamental Utility of the Incentive

The "Manufacturers' Pro-Growth Agenda" sponsored by the NAM includes the following item:

> Support Technological Innovation. Reduce the number of federal labs and more precisely define their mission to avoid public-/private-sector competition. Make remaining federal R&D activities more cost-effective and more private-sector-oriented. Encourage appropriate, industry-led technology partnerships with government. Reduce existing regulatory obstacles to innovation and to the rapid diffusion of new technologies, and avoid enacting new regulatory obstacles.

The NAM believes the credit should be evaluated considering the suggested reduction in federal labs with a view toward using that cost saving to further encourage private R&D through an enhanced credit.

While the credit has been effective in encouraging private R&D, many companies that have made substantial investments in research and development do not benefit from the current credit. This is due to the structure of the current credit that is available only to the extent that a company's current ratio of R&D expense to sales exceeds the same ratio for the 1984-1988 base period.

A company may actually increase R&D spending and still be ineligible for the credit. This can occur for a number of reasons relating to business developments such as the acquisition of a less R&D intensive subsidiary or a rapid increase in sales for cyclical industries. In these cases, a company could be denied the credit for reasons unrelated to its overall research efforts.

The NAM believes Congress should consider providing an alternative, elective credit that would be available to these firms that conduct critical research activities, but that for a variety of reasons have not been able to qualify for the incremental credit using the existing base period.

The existing credit remains an effective framework from which improvement can be made. A large number of companies are investing existing amounts in R&D because of the credit. Because the present credit is scheduled to expire at the end of June, the NAM believes the entire framework will be in jeopardy if it is not renewed. It is of utmost importance that there be an uninterrupted continuation of the credit. The NAM encourages Congress to extend the credit in such a way so that it will work effectively for the broadest possible spectrum of industries.

Recommendation

The NAM urges that the R&E tax credit be extended and made permanent. That should be done this year retroactive to its expiration date. If sufficient funding is available, an enhancement should be made so as to support any productive R&D activities without the credit structure itself constituting an impediment to productive activities. One means to achieve this objective would be through an alternative, elective credit which would not disadvantage businesses currently earning the credit.

Summary

The health of the United States' economy and its favorable position in the world market is dependent on the manufacturing sector. The cost of capital is the most critical economic determinant in supporting a successful manufacturing community. The majority of private commercial R&D is conducted by manufacturing enterprises. R&D spending by United States manufacturers sustains growth and advancement in manufacturing technology enabling a healthy economy, creation of new jobs and maintaining the United States leadership in the global market.

TESTIMONY OF MIKE CUMMINS

VICE PRESIDENT

OF THE NATIONAL CENTER FOR MANUFACTURING SCIENCES

Madam Chairwoman and Members of the Subcommittee on Oversight:

The National Center for Manufacturing Sciences welcomes the opportunity to testify on the need to improve the research and experimentation (R&E) tax credit. More specifically, we would like to lend our support for, and offer our perspective on, an enhanced reward for research conducted collaboratively.

In sum, an enhanced reward for research conducted collaboratively will serve several important functions not currently served by the R&E tax credit. A modification for collaborative R&D will:

- reward currently underspent manufacturing process R&D of generic application to industry, which will ensure we not only innovate in new products, but have the ability to produce those products on competitive terms;
- permit small manufacturers to leverage resources and know-how with larger manufacturers to conduct joint R&D of importance to the supplier chain;
- encourage companies to do research in the most efficient manner possible, *i.e.* collaboratively, when the research would otherwise be duplicated and encourage new research that would not otherwise be done if R&D had to be conducted and paid for on an individual firm basis;
- cost effectively reward the deployment and commercialization of R&D, not just the ability of firms to spend more on R&D; and,
- widen the benefits of the R&D tax credit to firms currently not eligible for the credit and simplify administration of the credit.

The NCMS -- a 501(c)(3) not-for-profit manufacturing research and development organization -- is one of the Nation's leading R&D consortia, and the largest in the manufacturing realm. Comprised of predominately smaller manufacturers, the NCMS focuses on generic manufacturing process R&D -- R&D that is the building block for the conversion of raw materials to finished products.

The unique model of the NCMS, as a consortium of large assemblers and small suppliers, serves to maximize the benefit of every R&D dollar expended. First and foremost, the selection process for process R&D engages the expertise of a diverse group of participants, who not only see the process technology from its potential application to their unique product lines, but through their chain of suppliers. Such a selection process assures that the process technology has wide commercial application across industry, as well as defense application. The NCMS model avoids the problem encountered when individual firms undertake process R&D. Too often processes of considerable merit to a vast number of businesses are not made relevant and cost-effective because their application to industry is not fully utilized or even appreciated.

Second, since NCMS is governed by the highest quality principles synthesized across industries, the value of the process technology to NCMS members is always benchmarked against the regiments of quality. The consortia environment ensures that the procedures of the widest practicable application emerge, but also that these processes yield products of the highest quality.

Finally, as a consortium of variegated firms, NCMS' unique membership can accelerate the commercialization of process technologies. That is because the technology is instantly available to a base of manufacturers that represent a significant portion of the industry users.

In our testimony here today, we would like to discuss with this Subcommittee the need to understand the distinction between process and product R&D, the reason why process R&D is underspent, and why we believe a collaborative tax credit will address many of these problems.

I. Policymakers Must Understand the Essential Need for Collaborative and Process-Oriented R&D

The Congress and the Administration, regardless of whether either is in Republican or Democratic hands, perennially touts the need for R&D funding. At the state level, governors provide direct assistance to stimulate R&D and the fruits of increased productivity, higher paying jobs and the manufacturing productivity it embodies. And across our shores, virtually every developed country finds ways in which to reward R&D. The need for R&D, and for government incentives for R&D is permanently etched into the American psyche.

But expressions of support for the idea of promoting R&D, as this committee has heard from many witnesses here today and over the last ten years, is the easy task. What is more difficult is determining how to translate that support into concrete proposals to encourage R&D. Equally important is determining what form of R&D should be rewarded.

Recognizing that we underspend in R&D, therefore, is only part of the story. We must appreciate the critical distinction between product and process R&D, we must attempt to quantify and understand the causes of underspending, and we must -- most importantly -- take steps to direct additional resources to process R&D commensurate with its importance.

Process R&D is Critical to Manufacturing Competitiveness

In its most basic form, manufacturing can be defined as the conversion of raw materials into finished products with defined shape, structure and properties that fulfill given requirements, specifications and quality levels.[1] This conversion into finished products is accomplished using a variety of processes that apply energy -- be it electrical, mechanical, thermal or chemical in nature -- to produce the desired changes in the configuration of materials. The means by which this conversion is effected is collectively known as 'manufacturing process', and the study of how to most efficiently effect this conversion is the study of manufacturing process technology.

Manufacturing process R&D matters, because it is the key to competitiveness of manufacturing sector. Every nation's success as a global manufacturer requires the development and use of processes capable of producing high-quality products rapidly, cost-effectively, and in an environmentally acceptable manner. U.S. companies must be able to manufacture products of superior quality at competitive prices, and the key to the quality of any product is an understanding of the manufacturing process by which it is produced and an understanding of the most efficient means to implement that manufacturing process knowledge.

Evidence of the criticality of process R&D, can certainly be found in the concerns advanced by policymakers. Numerous studies which have been undertaken to define the most important areas of future industrial research have emphasized the need to place manufacturing process development on an equal basis with new product technologies. According to these studies, the U.S. must establish a permanent foundation in engineering and science which is capable of innovating and improving not only products, but the processes by which they are produced. For instance, the report of the National Research Council, Materials Science and Engineering in the 1990s: Maintaining Competitiveness in the Age of Materials, highlights materials synthesis and process as an important area of expanded emphasis over the next decade (NRC 1989). Other studies point out that the reason for the loss of manufacturing competitiveness and productivity has been a reduction in investment in manufacturing process R&D; indeed, that the U.S. focus on products rather than processes has been fueling the relative decline of American manufacturing with respect to other manufacturing nations.[2] [3]

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[1] Unit Manufacturing Processes, National Research Council, National Academy Press (1995).

[2] Thurow, L. 1987. A weakness in process technology. Science 238:1659 -1663.

[3] Mettler, R.F. 1993, Forging the Future: Policy for American Manufacturing, 1993. Washington, D.C.: Report of the Manufacturing Subcouncil, Competitive Policy Council.

These studies are bolstered by everyday observations. Although global integration of product markets and advances in reverse engineering techniques have improved the ability of competitors to determine the compounds of new products, the ability to clone products still depends on competitors' ability to make those compounds. Excellence in developing and implementing manufacturing processes that produce unique production capabilities with cost and quality advantages are determinants of market success, since processes and investment in capital and training costs cannot be easily duplicated.

Process R&D Assists Production in Many Ways

Manufacturing process occupies a central role in our economy because of its ability to increase affordability and quality of the products, decrease time to market and time for commercialization, broaden applications of products, and incorporate environmental or other externalities. Each factor deserves elucidation.

First, manufacturing process R&D adds greater affordability to production; indeed, affordability is one of the seven industrial thrusts identified by the Department of Defense in determining the priority of Manufacturing, Science and Technology funding. One of the basic values of process technology is its ability to provide the required quality level of transformation at minimum input cost per unit of output. This involves minimization of such factors as energy use, scrap generation, capital and labor costs.

Second, manufacturing process technology can find new uses for advanced materials. Often advanced materials with outstanding properties are simply left unused or languish in a single laboratory or corporation since little consideration had been given to the methods required to produce them. Understanding process helps us understand the possible uses to which such material can be put.

Third, manufacturing process technology can shorten the time to transform a product technology from research to commercialization by rapid response to customer needs. One of the critical understandings in research today, is the need, developed by industry and adopted by the Department of Defense, to have concurrent process and product technology, otherwise known as Integrated Product and Process Technology. Though concurrent process R&D we can achieve production more successfully, with more quality and with greater speed. Of course, process R&D can shorten the time of production, which is particularly important if the process is the limiting factor in bringing the product to market.

II. Why do We Underspend on Process R&D?

The failure of market forces to provide for an adequate level of manufacturing process R&D results from the economics of R&D spending, particularly the unique economics relative to manufacturing process R&D. As a general proposition, firms tend to underspend on R&D since they are unable to translate into profits all of the value their R&D adds to the economy; but this "innovation gap" is widest for manufacturing process R&D where the return to the individual firm is perceived to of less advantage to the firm than to the manufacturing community as a whole.

Individual firms tend to underspend in manufacturing process R&D. Both product and process R&D may entail large costs, high risks and long term payoffs. The potential gain for any one firm from process technology is limited by the use to which the firm can apply the technology in their own operations. The R&D may result in technology that will reduce their costs, allow a lower pricing structure and improve market share to some extent. It will not expand their revenues to the same dramatic degree that a new and innovative product will. And since they are not in the manufacturing technology business, they will not typically know how to enter an entirely new and different market based on the improvement. The process improvement, however, probably has wide application throughout their industry and in others. Thus the gap between the return to the firm (defined by the reduction in costs in its plants) and the potential return to society (lower costs and higher productivity in innumerable firms and often across industries).

Manufacturing R&D has the widest possible application of almost all R&D besides basic research but perhaps the lowest potential return to a particular firm. While few firms may be able to utilize a product innovation, many firms can find application to improvements in the processes by which that product is made. This dichotomy—the value to the industry or industries that would benefit from the technology vs. the inability of firms to typically receive a modest cost savings from their manufacturing R&D investment—causes individual firms to collectively underspend on process R&D at a level which exceeds the level firms underspend on R&D in general.

There is another reason that process R&D is relatively underfunded compared to product R&D. Protecting a firm's intellectual property in a product innovation is relatively direct. If a firm loses sales to a competitor using patented or otherwise protected product technology, it will quickly find out since exploiting the purloined technology necessarily involves third parties (i.e. customers). It may then enforce its legal rights (at least domestically and in most advanced countries). Process R&D may, in contrast, be used to good effect by a firm internally in its plant. It is therefore vastly more difficult to discover violation of a firm's intellectual property rights. This difference increases the risk and reduces the return on process R&D. This difficulty in protecting property rights makes it more likely that the firm will elect to perform product R&D even though the economic benefit to society would be higher were more R&D dollars allocated to process R&D.

Although it is not a particularly simple task to determine whether process R&D is being underspent in the private sector, the ability or failure of firms to compete successfully against domestic and foreign competitors gives a fairly direct measure of the productivity of their manufacturing operations and the efficacy of their manufacturing processes. In the case of defense suppliers, who are typically manufacturing a unique product with one buyer, it is more difficult to gauge the proper level of defense process R&D spending.

III. Why are Added Incentives for Collaborative R&D are Needed?

There are many reasons why a collaborative R&D tax credit is needed.

The Collaborative Credit Overcomes An Inherently Institutional Bias Against Collaboration and a Built-in Reluctance to Collaborate

Most importantly, the credit is needed to overcome a bias against collaborative research that has been institutionalized in the American business culture. Historically, antitrust laws and our traditional image of stubborn independence have combined to characterize collaborative research not only as a sign of weakness, but as an approach that could restrict competition or trade. As a result, most American companies have been reluctant to share manufacturing information and technology, even when their problems are industry-wide and solutions are long-term, costly and risky.

The credit would be the next logical step in a series of steps undertaken by Congress to remove institutional obstacles to collaborative research. In 1984, Congress passed the National Collaborative Research Act, which was intended to assuage fears that collaborative research (through the prototype stage) violated U.S. anti-trust statutes. In addition, the Stevenson-Wydler Technology Act of 1980, the Federal Technology Transfer Act of 1986 and the Omnibus Trade and Competitiveness Act of 1988 have all increased the abilities of American companies to engage in collaborative research.

In addition to overcoming cultural biases, the credit is needed to overcome internal perceptions that collaboration will hinder rather than help. R&D goes to the very heart of a firm's existence. Innovation, technology, knowledge and discoveries are the lifeblood of a firm; they are the means by which a firm gains marketshare. But these commodities only have value if they are either unknown to other firms or protected under intellectual property laws.

By asking firms to collaborate on R&D, we are asking them to share with others -- mostly competitors -- some of this knowledge. Collaborative R&D is new, difficult to organize and carries substantial perceived risks to firms. For an aggressive growth company, fear of "contributing knowledge" to competitors instead of "sharing" in the new knowledge is very real. And the collaborative group activity is subject to less individual corporate control, which elevates this concern.

The Collaborative Credit Furthers Sound Policy Goals of the Incremental Section 41 Credit

The collaborative R&E tax credit strongly advances the policy justifications of the section 41 incremental credit, and at the same time, rewards the most efficient use of limited R&D funds. The collaborative credit has much to recommend it: to the extent the credit leverages research dollars it encourages more efficient use of limited R&D resources; to the extent it spreads risks and costs; it encourages new research that would not be conducted in its absence; and, to the extent it eliminates redundant research, it increases the stimulating effect of the existing tax expenditures.

First, the collaborative R&D tax credit will stimulate new R&D (as the incremental Section 41 credit is intended to do). This is because the credit enables firms to spread risks and costs by pooling cash, in-kind contributions, scientists and technical know-how on R&D that would otherwise be too costly, too risky or too long-term to perform individually.

Second, the collaborative credit will advance the underlying goals of Section 41 by ensuring the research is conducted in the U.S. and by better enabling firms to meet foreign competition. The collaborative R&D tax credit is intended not only to help firms compete against one another, but to band together to meet global competition.

The Credit Will Benefit Firms Not Encouraged by the Current Incremental Credit

Direct benefits of the proposed enhancement to the R&E tax credit will undoubtedly inure to the bottom line of companies that conduct collaborative research. The collaborative credit will assist companies that are otherwise increasing their R&E expenditures above the "base," regardless of how that base is defined in the section 41 incremental credit. Equally important, however, it will also benefit companies that cannot take immediate advantage of the incremental credit either because they do not have taxable income against which the credit can be offset, are subject to the limitations of the Alternative Minimum Tax or whose R&D falls below the base. It also includes smaller firms who may be disinclined to invest the needed amounts in process or other technologies not perceived to immediately inure to the bottom line, but in the long run are key to their sustained competitiveness.

The ability to share in the research results of collaborative research that is "incentivized" or encouraged by the enhanced credit is a direct benefit that will inure to all participants in a collaborative venture. In other words, because the research is collaboratively conducted (and financing is interrelated), lowering the costs of capital outlays lowers the cost of capital for the research venture in its entirety. In essence, the leveraged research is disseminated to small and large firms alike, for-profit and currently not-for-profit firms alike, and the indirect benefit of the credit is spread to the entire membership of the project. For firms that are below the "base", collaboration will allow them to "catch up to the fold" with immediately rewardable R&E expenditures.

The Credit Will Efficiently Stimulate R&D to the Benefit of the Public and the Public Fiscal Interest

A common test of the utility of the credit has always been how much research it stimulates, but this is far from a perfect criterion as pointed out in the testimony of the GAO. A more correct measure of the utility of an R&E tax credit is how efficiently the credit promotes research, how quickly it facilitates dissemination of research results, and how effectively it assists in the commercialization of innovations within short time frames. The credit should not be judged

simply by how much R&D dollars it stimulates, but by the knowledge conveyed and deployed by the R&D performing firm.

The collaborative R&D tax credit induces new research at lower costs to limited public resources (in the form of tax expenditures) and lower costs to increasingly limited private resources. It helps companies make more efficient use of limited resources by overcoming transactional and cultural barriers to collaboration, providing a counterbalance to perceived or real disadvantages from disclosure of information. Moreover, it will reduce redundant research on which the incremental credit is now taken, ensure innovations are considered for the widest possible application, enable U.S. companies to bring technology to market faster on a wide variety of applications by involving more partners and employ teamwork to meet new challenges in the global trade environment.

The savings of finite public and private sector R&D resources and the new generation of R&D activity will inure to the benefit of the consumers in safer, more economical and more efficient products of greater variety.

The Credit Will Close the Wider Gap Between Societal and Economic Returns

It is generally recognized that firms will under invest in R&D. The prospect of recapturing income from a new idea is the primary incentive for commercializing new products or developing new processes. But individuals or firms that undertake R&D of new technologies must always balance the prospect of return with the cost of that R&D, the risk of failure and the consideration that, even if they are successful, they will not be able to reap the profits attributable to the new technology.[4] A firm that is efficient in finding new technologies is not always poised to best manufacture and distribute the product, or otherwise fully capitalize on that technology. In short, firms have difficulty capturing the benefits of research to the same extent those benefits inure to society.

The R&D tax credit is partly meant as a means to balance this market distortion by bridging the gap between the social rate of return and the economic rate of return to the individual firm. To the extent the gap between social and economic rates is closed, actual market forces can work more effectively to properly allocate sufficient funding to R&D. The credit also counters similar incentives provided for by our competitor-nations.

In collaborative research, however, even greater gaps between economic income and the social rate of return are present, and even greater competitive pressures come to bear. The greater gap between societal and individual rates of return stem from two factors: first, that the social rate of return is higher per dollar of R&D expended; second, that the firm has greater difficulty recapturing investment. As noted, because companies are sharing research results with competitors -- even if the consortia involves vertical components -- the starting line for competition is advanced for all participants. No individual firm, therefore, gains relative advantage over another in collaborative research. This inability to recapture relative income gain widens the gap between the firm's perceived individual return, and the benefit to the public. The collaborative R&D tax credit modification is meant to stimulate two principal policy goals of the Section 41 credit: (1) it is intended to stimulate new research, and (2) it enables firms to recapture the economic profits of R&E outlays, when these are the most difficult to be recaptured.

The Credit Redresses Certain Inequities

The tax credit for consortia research is also needed because the Code can treat collaborative research disadvantageously. As previously discussed, outside contract expenses are currently creditable, if at all, to the extent of 65 percent. Therefore, contributions to research consortia are not fully creditable as in-house expenses. This 65 percent contract limitation is not without an ostensible policy goal: it is meant to reflect the cost of in-house research overhead, and therefore,

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[4] While research may result in large dividends to firms that conduct such research, such firms are reluctant to conduct research because of the long-term nature of the rewards and because of the fear that the innovation or new processes developed from this research will be lost to competitors.

equalize the treatment between in-house and contracted research. However, the reasoning behind the policy is flawed: it is precisely the lower overhead costs of research consortia and the higher return per dollar of contribution which recommends collaborative research.

Conclusion

It is time for a domestic tax policy that rewards R&D conducted collaboratively as part of our current tax incentive system for R&D. The credit leverages research dollars and encourages more efficient use of limited R&D resources. The credit also spreads risks and costs and encourages new research that would not be conducted in its absence. Finally the credit eliminates duplicative research, thereby reducing the tax expenditure. For these reasons the NCMS recommends that national tax policy incentivize collaborative R&D.

National Society of Professional Engineers

Statement
of the
National Society of Professional Engineers
on the
Research and Experimentation Tax Credit

May 24, 1995

The National Society of Professional Engineers supports legislation (S. 351/H.R. 803) to make permanent the tax credit for research and experimentation. The R&E tax credit is one of the most effective ways the government can encourage private sector research and development.

The National Society of Professional Engineers (NSPE) was founded in 1934 and represents over 65,000 engineers in over 500 local chapters and 52 state and territorial societies. NSPE is a broad-based disciplinary society representing all technical disciplines and all areas of engineering practice, including government, industry, education, private practice, and construction.

The R&E tax credit, provided in Section 41 of the Internal Revenue Code, allows taxpayers to claim an incremental credit for R&E expenditures. Because the credit applies only to R&D expenditures that exceed a base R&D investment amount, it encourages the beneficiaries to increase their level of R&D investment beyond what they would normally have conducted without the credit. The tax credit also counters one of the primary disincentives to private sector R&D - the financial disadvantage incurred by a firm that conducts research, only to have their competitor gain access to the new technology, without having incurred the research expense themselves. In a sense, the tax credit "reimburses" those industries whose research benefits the economy as a whole.

Also, because the R&E credit applies to contract research conducted on the taxpayer's behalf, as well as to in-house R&D, the credit may in some cases stimulate greater cooperation between industry and academia. Both industry and academia benefit when certain academic research is directed to specific industry needs.

Unfortunately, the R&E tax credit has been subjected to short-term extensions. As a result, beneficiaries have not been able to make long-range business plans with confidence. In fact, some eligible participants may have chosen not to avail themselves of the tax benefit as a result of the uncertainties involved. In effect, the short-term nature of the provision has diminished its potential to effectively meet our important research needs. We are confident that the impact of the R&E credit will be magnified when it is made a permanent component of the tax code.

The R&E tax credit is a sensible use of tax policy to enhance our nation's long-term economic competitiveness. It has our full support.

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Our Business is Your Success

STATEMENT OF ROBERT S. GREGG

SENIOR VICE-PRESIDENT OF FINANCE, LEGAL,
TREASURER AND CFO
FOR SEQUENT COMPUTER SYSTEMS, INC.
BEAVERTON, OREGON

RESEARCH AND DEVELOPMENT CREDIT

BEFORE THE HOUSE WAYS & MEANS COMMITTEE
SUBCOMMITTEE ON OVERSIGHT

UNITED STATES HOUSE OF REPRESENTATIVES

MAY 10, 1995

Madame Chair and Members of the Subcommittee. My name is Bob Gregg. I am the Senior Vice-President of Finance and Legal, Treasurer and Chief Financial Officer of Sequent Computer Systems (Sequent). I respectfully submit this written testimony on behalf of my company. As a member of the American Electronics Association (AEA), we are asking for your help in seeking legislative relief from a technical glitch in the R&D tax credit definition of start-up companies.

Sequent is based in Beaverton, Oregon, and is a leading architect of enterprise information technology solutions. In 1994, Sequent had approximately 1800 employees worldwide, with approximately half of our total revenue coming from sales outside the U.S. from research and development and production of products within the U.S.

The unintended glitch in the tax law severely impacts Sequent and has resulted in our receiving no R&D credit since the structure was changed in 1989, even though our research expenditures have increased over 700 percent since the inception of the company to over $60 million annually and have contributed to the employment of over 300 highly skilled engineers in Oregon and over 600 technically skilled support personnel.

Sequent was founded in 1983 by 18 former Intel employees with a vision of the future and with the innovative spirit that the R&D credit was designed to encourage. As a result of our successful R&D efforts in the middle 1980's, Sequent has grown from being a start-up company just over 10 years ago to the mid-sized company that it is today. Our success is largely due to the research and development undertaken by Sequent to design and manufacture a new generation of large commercial computer systems (which have come to be known as symmetric multiprocesssing computers).

Sequent believes that the R&D credit is a very important tool to US tax policy. We are committed to the R&D credit because prior to the change in the calculation with the technical glitch, the credit had a real impact on the decisions of Sequent and other young companies like us. This research has in turn allowed us to stay ahead of our foreign competition in the computer systems business. As a result, we know the R&D credit has a direct and clear impact on our future investment in research and it is critical that a technical glitch in the definition of a start-up company not put us at a competitive disadvantage.

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TAX LAW REVISIONS FAIL TO ENCOURAGE ALL START-UP'S

As previously mentioned, Sequent was incorporated in 1983. We began R&D in 1983 and introduced our first product in December 1984. While we continued to invest significantly in R&D during the fixed base period of 1984 to 1988, our sales volume reached only $76 million by 1988, the last year of the fixed base period. In contrast, our revenue for 1994 was over $450 million. During the critical period of 1984 to 1988, our average percentage of qualified research expenses to sales was over 15%, significantly higher than our current qualified R&D to sales ratio. Because only incremental R&D spending above the base qualifies for the credit, when applying the fixed base percentage for the period 1984-1988 to the average of our gross receipts for the most recent 4 years, the result is a base so high that even as our R&D spending increases, we will not be entitled to an R&D credit for any future year.

Acknowledging that companies in a start-up phase will experience a distorted relationship between R&D expenses and gross receipts in their initial years of operation, Congress provided a special fixed base for start-up companies. We failed to qualify as a "start-up company" for purposes of the special base period relief because we had more than de minimis sales in 3 out of the 5 years of the fixed base period (1984-1988) even though we were clearly a start-up company during that period of time and in fact Sequent's R&D as a percentage of sales was well over 100% in some years during the base period. The credit's incentive value is zero for a few companies like Sequent.

More importantly, the current start-up company definition puts Sequent at a significant disadvantage when we try to compete with an already established company, or a new company who currently qualifies as a start-up company. These companies will get a 20% incentive for their incremental R&D spending. This comes at a time for us when technologies must be developed so that exciting new products can replace the mature products that drove much of our past growth.

We understand from those involved in putting the provision together back in 1989 -- and from the AEA representatives that were consulted at that time -- that this result was never intended. Rather, companies like us within AEA were simply too small to be aware of various congressional proposals back then, and so we never found out about it until it was too late.

THE PROPOSAL

The proposal that solves this problem is simple. ***It would change the definition of a start-up company to include any company with its first year of both R&D and sales in 1984 and thereafter.*** Indeed, this fix was included in H.R. 11 in 1992, which was vetoed by President George Bush for reasons unrelated to this issue. At the time, the cost over 5 years was estimated to be under $50 million. I hope that you will seriously consider fixing this problem to ensure that start-up companies like Sequent who began business during the early years of the fixed base period (1984, 1985 or 1986) are not penalized merely for the year they were formed.

CONCLUSION

Legislative relief is necessary to ensure that "notch" companies such as Sequent are not at a competitive disadvantage vis-a-vis, our competitors. We urge Congress to review this issue and to take action now on behalf of companies whose situations apparently were overlooked during the struggle over bigger issues in the 1989 research credit revisions.

STATEMENT
on the
RESEARCH AND EXPERIMENTATION TAX CREDIT
and the
ALLOCATION OF RESEARCH AND DEVELOPMENT EXPENSES
UNDER IRC SECTION 861
for submission to the
HOUSE COMMITTEE ON WAYS AND MEANS
SUBCOMMITTEE ON OVERSIGHT
for the
U.S. Chamber of Commerce
by
William T. Sinclaire
Senior Tax Counsel and Director of Tax Policy
May 10, 1995

The U.S. Chamber of Commerce appreciates this opportunity to express its views on the research and experimentation (R&E) tax credit and the research and development (R&D) expense allocation rules. The Chamber is the world's largest business federation, representing 215,000 business members, 3,000 state and local chambers of commerce, 1,200 trade and professional associations, and 72 American Chambers of Commerce abroad.

Research and Experimentation Tax Credit

The R&E tax credit contained in Section 41 of the Internal Revenue Code was designed to reward businesses for increasing expenditures in R&D. However, the R&E tax credit is due to expire on June 30, 1995, and the Chamber believes it should be made permanent because it benefits the overall economy in both the short and long term.

The best way our country can maintain its competitive edge in the global economy is through increased innovation and technological development. R&D cycles can last for many years, and high levels of R&E must be performed continuously to achieve desired results. Because the R&E tax credit stimulates innovation and product development, it should not only be extended, but should be made permanent so companies can rely on it during their budgetary processes.

The R&E tax credit was initially enacted as part of the *Economic Recovery Act of 1981*. Originally, the credit was equal to 25 percent of the excess of qualified research expenses incurred in the tax year over the average of qualified research expenses incurred in the three prior tax years. The credit was to expire at the end of 1985; however, it was extended through the end of 1988 by the *Tax Reform Act of 1986*. This act also modified the credit by (a) reducing the credit to 20 percent, (b) tightening the definition of the expenses eligible for the credit, and (c) enacting a separate, university basic research credit. Thereafter, the *Technical and Miscellaneous Revenue Act of 1988* extended the credit through the end of 1989 and reduced the deduction allowed for qualified research expenses by an amount equal to 50 percent of the credit determined for the year.

The *Omnibus Budget Reconciliation Act of 1989* extended the R&E tax credit through the end of 1990 and further reduced the deduction allowed for qualified research expenses by an amount equal to 100 percent of the credit determined for the year. The *Omnibus Budget Reconciliation Act of 1990* extended the credit through the end of 1991.

The research tax credit was extended for an additional six months through June 30, 1992, by the *Tax Extension Act of 1991*. The *Omnibus Budget Reconciliation Act of*

1993 extended it further through June 30, 1995, and amended the rules determining the fixed-based percentage of start-up companies.

With the R&E tax credit having been renewed six times and modified four times since 1981, uncertainty abounds in the business community and long-term planning for R&D can be precarious. This uncertainty reduces the incentive value and effectiveness of the credit. In order for businesses to make the necessary time and cost commitments for initial and continuing R&D projects, a permanent credit is required.

A permanent R&E tax credit will remove uncertainty and allow businesses to plan and undertake long-term research projects. This will enhance American technology, increase our productivity and competitiveness in the global marketplace, create high-paying jobs, and improve our overall quality of life.

Research and Development Expense Allocation

American businesses that conduct most of their R&D in the United States are at an international competitive disadvantage if they have foreign operations with foreign source income. The R&D allocation regulations (861 allocation regulations), contained in Section 1.861-8(e)(3) of the Treasury Regulations, were first issued in 1977 and have been debated significantly ever since. This debate has developed because U.S. multinational companies with foreign source income are required, for purposes of determining their foreign tax credits, to treat a portion of their domestic R&D expenses as if the R&D was conducted abroad. This has effectively led to double taxation for American companies, since no foreign country allows a deduction for R&D conducted in the United States.

The requirement that a portion of R&D performed in the United States be treated for tax purposes as if it were conducted in a foreign country creates a disincentive for American businesses to undertake R&D in the United States and encourages the movement of R&D abroad. Moving R&D out of the United States runs counter to the goal of fostering investment in R&D in this country and is clearly not in our national best interest.

The double taxation problem arose when the Treasury Department first drafted the 861 allocation regulations in 1977. Since then, a number of measures designed to prevent the full implementation of the regulations have been advocated and adopted by subsequent Administrations and Congresses. Starting in 1981, and continuing through 1986, the 861 allocation regulations were suspended and taxpayers were allowed to allocate 100 percent of their U.S. R&D expenses to U.S. source income, irrespective of their worldwide sources of income. In 1987, this suspension was modified to allow a 50 percent exclusive apportionment to U.S. source income. From 1988 to 1992, with the exception of a short period during 1988 and 1989, a series of provisions were enacted to generally permit a 64 percent exclusive apportionment of U.S. R&D expenses to U.S. source income.

In 1992, the Treasury Department effectively allowed taxpayers to elect out of the 861 allocation regulations for two years in exchange for other rules when it announced that it was undertaking a review of the regulations to determine if they provided for a proper allocation or apportionment. Thereafter, further legislation suspended the 861 allocation regulations through December 31, 1994.

Unless there is a regulatory or legislative solution, the 861 allocation regulations drafted in 1977 will apply to all tax years beginning after 1994. American multinational

businesses involved in U.S. R&D will effectively be subject to double taxation to the extent U.S. R&D expenses are allocated to non-U.S. source income.

The Chamber believes that a permanent resolution to the 861 allocation regulations issue is necessary to ensure that the goal of encouraging American companies to invest in R&D within the United States is achieved. American technology has been a major source of our export strength and world leadership. U.S.-based R&D is essential to sustaining America's competitiveness and is critical to our nation's continued economic growth. Advances in technology are vital to creating high-wage jobs and enhancing the position of American businesses in the world economy.

Conclusion

The Chamber urges enactment of a permanent R&E taxcredit and finality to the 861 allocation regulations issue. Making the R&E tax credit permanent will best serve the country's long-term economic interests because it will eliminate the uncertainty about the future of the credit and permit businesses to make important R&D business decisions with certainty. Innovation greatly contributes to overall economic growth, increases productivity, creates new, better and higher-paying jobs, and allows for a higher standard of living. Providing for a favorable and definitive resolution to the 861 allocation regulations issue is essential to having an environment that is conducive to R&D investment in the United States. It is necessary that R&D remain in this country so that high-paying jobs do not move abroad. American technology has been a major source of U.S. export strength and is vital to American businesses remaining in leadership positions in our global economy.

STATEMENT ON BEHALF OF THE

UNITED STATES TELEPHONE ASSOCIATION

The United States Telephone Association ("USTA") is pleased to have this opportunity to submit testimony to the Committee on Ways and Means concerning the extension of the research and experimentation tax credit ("credit"). USTA is the primary trade association of local telephone companies serving more than 98 percent of the access lines in the United States and represents over 1100 members from the smallest of independents to the large regional Bell companies.

USTA supports permanent extension and urges Congress to refrain from efforts to once again modify the credit.

As the information age continues to advance in both technology and reach, the credit becomes increasingly important for precisely the reasons which prompted Congress to adopt it originally: it provides a real incentive for U.S. companies in our rapidly changing industry to increase and expand their level of commitment to tomorrow's world of communication. As such, it encourages investments in innovation, productivity gain and international competitiveness notwithstanding their risk. The presence of a stable, unchanging credit mechanism is the best insurance that we will continue our position as a world leader in communications by producing new products and technologies despite the risks associated with their development. The credit also encourages new jobs as technology-driven services and products made possible by research and experimentation are brought to the marketplace.

The velocity of change in telecommunications is astonishing and accelerating. The life-cycle of new modes of communicating is increasingly short, with advancement and transformation occurring world-wide. Our membership competes for business in this fast-paced marketplace. Foreign entities and governments benefit from incentives sometimes two-thirds greater than any available in the United States. The credit helps offset that potential investment imbalance.

The Committee, in its proper focus on the credit, is looking at its effectiveness and what steps might be taken to improve its utility. Probably the most important action that could be taken would be to permanently extend the credit. In so doing, our industry, and every other one dependent on research for its future, would be able to plan for the long-term, no longer concerned, as we are today, about uncertainty regarding the availability of the credit. Over the last several years, Congress has always extended the credit but many times with narrowing modifications and at times retroactively. This has had the impact of reducing its attractiveness as an incentive upon which strategic planning could be based. We would ask the Committee to refrain from efforts to again transform the credit as it is made permanent. It would be disruptive of the goal of permanent extension to do so in that businesses would have to take the next several years to learn about and cope with additional modifications. Such changes are not without their impacts. For example, commitments to research are not merely made in dollars but also include the hiring of talented and dedicated academics and scientists. Over the last several years, fewer commitments in human terms could be made given the "year to year" existence of the credit. Permanent extension would reverse that situation.

We are not unmindful of the difficult budgetary issues confronting the Committee as it considers extension of the credit. USTA supports the desire to reduce government commitments. The extension of the research and experimentation credit, however, is one of the intelligent choices Congress can make in order to ensure that the U.S. remains a world leader in communications.

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